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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1941

No. 283

BUTLER BROTHERS, APPELLANT,

vs.

CHARLES J. McCOLGAN, AS FRANCHISE TAX COMMISSIONER OF THE STATE OF CALIFORNIA

APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA

FILED JULY 19, 1941.

SUPREME COURT OF THE UNITED STATES

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IN THE SUPERIOR COURT OF THE STATE OF CALIFORNIA, IN AND FOR THE CITY AND COUNTY OF SAN FRANCISCO

No. 277004

BUTLER BROTHERS, a Corporation, Plaintiff,

vs.

CHARLES G. JOHNSON, as Treasurer of the State of California, Defendant

COMPLAINT—Filed October 18, 1937

Plaintiff complains of defendant and for cause of action alleges:

I

Plaintiff is now and at all times herein mentioned has been a corporation organized and existing under and by virtue of the laws of the State of Illinois and qualified to conduct business in the State of California.

II

Defendant is now and at all times herein mentioned has been the duly elected, qualified and acting Treasurer of the State of California.

[fol. 5]

III

Pursuant to the provisions of the Bank and Corporation Franchise Tax Act, plaintiff, within the time provided by said Act, filed its return for the calendar year 1935 showing that for said year plaintiff derived no net income from business done within the State of California. At the time of filing said return plaintiff paid the minimum tax of Twenty-five Dollars ($25.00) provided by law. Subsequently, on January 25, 1937, the Franchise Tax Commissioner of the State of California gave notice to plaintiff of a proposed assessment of an additional tax of Three Thou-

sand Seven Hundred Ninety-eight and 43/100ths Dollars ($3,798.43). Thereafter, and within sixty days after the mailing of said notice, the plaintiff filed with said Commissioner a written protest under oath, protesting the levy of the proposed additional tax and specifying the grounds upon which such protest was based. A copy of said profest is hereto attached, marked Exhibit "A" and made a part hereof. Thereafter, and on August 5, 1937, said Commissioner mailed written notice to plaintiff that he had affirmed such proposed additional assessment, and on September 8, 1937, said Commissioner assessed such additional tax in the amount of Three Thousand Seven Hundred Ninety-eight and 43/100ths Dollars ($3,798.43), with interest thereon from March 15, 1936. Thereafter, and on September 16, [fol. 6] 1937, plaintiff paid to defendant, as Treasurer of the State of California, said sum of Three Thousand Seven Hundred Ninety-eight and 43/100ths Dollars ($3,798.43), together with interest thereon in the amount of Three Hundred Forty-four and 67/100ths Dollars ($344.67). Said payment was made under protest, which protest was in writing and under oath, and stated the grounds upon which plaintiffs claimed that said additional tax and all thereof is and was void. A copy of said protest is hereto attached, marked Exhibit "B" and made a part hereof.

IV

Said additional assessment and all thereof was and is void for each and all of the reasons and grounds set forth in said protest (Exhibit "B" hereto), to which reference is hereby made, and the same is incorporated herein as if herein set forth at length.

Wherefore, plaintiff prays judgment against defendant for the sum of Four Thousand One Hundred Forty-three and 10/100ths Dollars ($4,143.10) so paid as aforesaid and for interest thereon as provided by law from the date of payment, and for such other and further relief as may be meet and proper in the premises.

Brobeck, Phleger & Harrison, Attorneys for Plaintiff.

[fol. 7] *Duly sworn to by F. S. Cunningham. Jurat omitted in printing.*

[fol. 8] EXHIBIT "A" TO COMPLAINT

Protest of Butler Brothers to Proposed Additional Franchise Assessment for Taxable Year ended December 31, 1936

Charles J. McColgon, Franchise Tax Commissioner, Sacramento, California.

Re No. 8350

DEAR SIR:

Protest is herewith made to your proposed additional franchise tax assessment amounting to $3,798.43.

The proposed additional assessment is based upon the theory that the general net income of the undersigned from the whole of its business transacted in the United States should be allocated to the State of California upon the basis as set forth in Schedule J. of the return.

There was attached to the return a statement calling attention to the fact that the actual operations of the San Francisco branch house had resulted in an actual loss of $82,851 for the calendar year 1935, which statement was supported by a schedule attached showing the result of such operations. It is not understood that the figures there given are in any way disputed.

The question, therefore, is as to whether the statutory method of allocation should be given effect as against the actuality of the case.

[fol. 9] Any method of allocation of the kind set forth in Schedule J is to a large extent arbitrary and is intended, and can be sustained, only as a means for arriving at net income attributable to the business carried on in the State of California. If such a method of allocation, or if any statutory or arbitrary method of allocation, works out in actual practice with a reasonable approximation of income attributable to California the method will be sustained. If, however, such method does not so work out, and results, in practical effect, in attributing to the State of California an unreasonable amount of income as compared to the business of the company done in its entirety and in other jurisdictions, or creates in California an income non-existent in fact, the statutory method of allocation must give way, and will not be sustained.

The undersigned respectfully insists that inasmuch as the actual results of the operation of its business in the State of California is a loss the statutory method of allocation is inapplicable, and that therefore it is subject only to a minimum tax.

It is conceived that the position here taken is supported by *Hans Rees' Sons, Incorporated v. North Carolina*, 283 U. S. 123.

Undersigned again states and insists, as it stated and insisted in its return as filed, that to impose a tax based upon the method of allocation set forth in Schedule J of the [fol. 10] return is a violation of the undersigned's rights under both the California and United States Consfitutions. An oral hearing is requested.

Respectfully submitted, Butler Brothers, by Frank J. Kearns, Treasurer.

STATE OF ILLINOIS,
County of Cook, ss.:

FRANK J. KEARNS being first duly sworn upon oath deposes and says that he is Treasurer of Butler Brothers, the corporation whose name is subscribed to the foregoing protest; that he is familiar with the matters contained in said protest and that the same are true both in substance and in fact; and that as Treasurer he subscribed the name of said corporation to said protest and his own name as treasurer of said corporation.

Frank J. Kearns.

Subscribed and sworn to before me this 20th day of March, A. D. 1937. A. F. Bodenstab, Notary Public. (Seal.)

[fol. 11] EXHIBIT "B" TO COMPLAINT

Chicago, Illinois, September 10, 1937.

Hon. Chas. J. McColgan, Franchise Tax Commissioner, Sacramento, California and Hon. Charles G. Johnson, State Treasurer, Sacramento, California.

GENTLEMEN:

There is paid herewith the sum of $4,143.10, being the additional tax imposed for the taxable year ended December

31, 1936 on the undersigned under the Bank and Corporation Franchise Tax Act, as set forth in "Notice of additional franchise tax proposed to be assessed", dated January 25, 1937, and in "Notice of action of Franchise Tax Commissioner upon taxpayer's protest", dated August 5, 1937, in the amount of $3798.43, and interest thereon from March 15, 1936 in the amount of $344.67. Said sum and all thereof is paid under protest, the grounds of said protest being:

Butler Brothers is a corporation organized and existing under the laws of Illinois, doing business in the State of California. Its principal place of business is in the City of Chicago, County of Cook, and State of Illinois. It maintains and operates seven distributing or branch houses in the following localities: Chicago, Illinois; Minneapolis, Min-
[fol. 12] nesota; St. Louis, Missouri; Jersey City, New Jersey (which includes sales offices and sample rooms in New York City); Baltimore, Maryland; Dallas, Texas, and San Francisco, California. The business of the company is the wholesaling of general merchandise. It maintains at its San Francisco house a stock of merchandise from which orders received and accepted at San Francisco are filled. It also maintains in the City of Los Angeles a sales and sample room. Stocks of merchandise are also maintained at the above-mentioned distributing houses, out of which orders are filled in the territory tributary to said respective houses. All of the sales made by Butler Brothers in California and territory tributary to the San Francisco house are made through the San Francisco house (including the Los Angeles sales and sample room), and the San Francisco house, together with said Los Angeles sales and sample room, is the only part of its business conducted within the State of California.

Separate accounts are kept of the operation of each branch of the establishment of Butler Brothers, including the San Francisco branch. All merchandise sold therein is charged at actual cost and other expenses of conducting said business are directly apportioned to said San Francisco branch, so that the exact income and expenses thereof can be ascertained. During the calendar year 1935, said San Francisco
[fol. 13] branch operated at a loss of $82,851.00 and the minimum tax under the Bank and Corporation Franchise Tax Act, to wit: $25.00, was paid by said Butler Brothers on or about March 15, 1937.

The additional assessment, payment of which is herewith protested, is predicated upon the allocation to California of income of Butler Brothers derived solely from operation of its business in states other than in California, and no part of the net income of Butler Brothers is derived from business done within the State of California.

The allocation to California of income derived from business done without the State of California does not fairly or at all assign to the State of California the net income of Butler Brothers reasonably attributable to the business done within this state and subjects Butler Brothers to double taxation.

The method of allocation followed by the Franchise Tax Commissioner is arbitrary and unreasonable and does not fairly or at all allocate to California the net income derived from business done within the State of California. To the contrary, the same purports to allocate to California income derived wholly from business done without the State of California. In fact, no net income has been derived from business done within the State of California.

The tax assessed upon Butler Brothers by the Franchise Tax Commissioner is a tax upon business and transactions [fol. 14] conducted without the State of California, is without the power of jurisdiction of the State of California, will deprive Butler Brothers of property without due process of law, will deprive Butler Brothers of the equal protection of the law, and is in violation of its rights under the Constitution of the United States and the Constitution of the State of California.

The Bank and Corporation Franchise Tax Act, if construed as authorizing the assessement of the taxes here protested, is in violation of the Constitution of the United States and of the Constitution of the State of California.

Respectfully submitted, Butler Brothers. (Signed)
D. R. Treat, Comptroller.

State of Illinois,
County of Cook, ss.:

D. R. Treat, being the first duly sworn upon oath deposes and says:

That he is Comptroller of Butler Brothers, the corporation whose name is subscribed to the foregoing protest; that

he is familiar with the matters contained in said protest and that the same are true both in substance and in fact; and that as Comptroller he subscribed the name of said corporation [fol. 15] to said protest and his own name as Comptroller of said corporation.

(Signed) D. R. Treat.

Subscribed and sworn to before me this 10th day of September, 1937. (Signed) A. F. Bodenstab, Notary Public in and for the County of Cook, State of Illinois. (Seal)

[File endorsement omitted.]

In Superior Court for City and County of San Francisco

Answer—Filed November 27, 1937

Comes now the defendant above named, Charles G. Johnson, as Treasurer of the State of California, and answering the complaint on file herein admits and denies as follows, to-wit:

I

Defendant admits the allegations of the complaint on file herein except as hereinafter qualified.

II

Defendant denies all and singular, each and every, specifically and generally the allegations found in paragraph IV of the complaint on file herein, and further denies the allegations found in the protest which is incorporated in paragraph IV of the complaint on file herein.

[fol. 16] Wherefore, defendant prays that plaintiff take nothing by its action herein, and for costs of suit incurred herein.

U. S. Webb, Attorney General, H. H. Linney, Deputy, James J. Arditto, Deputy, Attorneys for Defendant.

[File endorsement omitted.]

IN SUPERIOR COURT FOR CITY AND COUNTY OF SAN FRANCISCO

STIPULATION AS TO CERTAIN FACTS—Filed July 21, 1938

It is hereby stipulated that the following facts, in addition to the facts alleged in the complaint admitted by defendant's answer herein, shall be deemed to have been proven by competent evidence:

1. Butler Brothers, plaintiff herein (hereinafter called the Company), is a corporation organized under the laws of Illinois and is qualified to conduct business in California. Its corporate principal place of business is in Chicago, Illinois. The Company is engaged in the wholesale dry goods and general merchandise business, purchasing from manufacturers and others, and selling such commodities to retailers only. It maintains and operates wholesale distributing houses at Chicago, Illinois, Minneapolis, Minnesota, St. Louis, Missouri, Jersey City, New Jersey, Baltimore, Maryland, Dal- [fol. 17] las, Texas, and San Francisco, California. The San Francisco house was opened by the Company in 1928, being the last established of all the Company's houses, except that the one at Baltimore was acquired as a going concern in 1930.

2. Stocks of goods are maintained at each of the Company's houses hereinabove mentioned, from which sales in the respective territories served by each house are made. Each house serves a separate trade territory, having its own sales force, and all sales made by the Company in the State of California are made from the San Francisco house. Each house handles its own sales and all solicitation, credit and collection arrangements in connection therewith. Books of account are kept at each house, wherein are entered the sales made thereat, the amounts paid for goods sold therefrom, transportation charges and other operating expenses, including the allocation of certain common expenses referred to in paragraph 4 hereof. It is agreed that all receipts from sales made in California have been credited to the San Francisco house.

3. The Company maintains a central buying division through which goods for resale are ordered, but such goods are shipped by the manufacturers to the houses for which ordered, where the cost thereof and transportation charges thereon are entered on the books of the house. No charges

are made against any house for the benefit of the Company [fol. 18] or any other house by reason of such centralized purchasing, but the actual cost of operating the centralized buying division is allocated to the houses, as stated in paragraph 4 hereof. The greater part of other operating expenses incurred by the Company are directly and exclusively incurred at the respective houses, including such items as labor, rentals and similar expenses.

4. There are certain items of expense which are incurred and paid by the Company for the benefit of all houses, the costs of which are allocated to the respective houses. No question exists as to the accuracy of the amounts of such expense or to the method of allocation employed, which is in accordance with recognized accounting practices. For the year 1935 the amount of such allocated expense charged to the San Francisco house was $100,091. For the purposes of this case, and without prejudice to the claims of either party in any subsequent year, it is agreed that approximately 75% of the $100,091 overhead expense so allocated would have been incurred even though the San Francisco house was not operated, and that the accuracy and propriety of the basis of allocation of such common expenses for the year 1935 are admitted. Included in such expenses are executive salaries, certain accounting expenses, the cost of operating a central buying division, and a central advertising division. Except for such common expenses, each house is operated independently of each other house.

[fol. 19] 5. The Company computed its income from the operation of the San Francisco house by deducting from the gross receipts from sales of merchandise in California, determined as indicated in paragraph 2 above, the costs of such merchandise, determined as indicated in paragraph 3 above, the direct expenses of the San Francisco house referred to in paragraph 3, and the indirect expense allocated to the San Francisco house in the manner described in paragraph 4 above. According to this computation, the San Francisco house operated at a loss of $82,851 during the year 1935.

6. The Company filed with the Franchise Tax Commissioner a report in the prescribed form, wherein it was reported that the San Francisco house was operated at said loss and, within the time provided by law, paid the mini-

mum tax of $25 for the year 1936. An additional assessment was made by the Franchise Tax Commissioner and paid by the Company as alleged in the complaint.

7. In the year 1935 the operations of all houses of the Company produced a profit of $1,149,677. The additional tax assessed by the Franchise Tax Commissioner was predicated on the allocation to California of 8.1372% of the total income of the Company derived from all sources, such percentage having been determined by mathematical average of the percentages which (a) value of real and tangible personal property, (b) wages, salaries, commissions and other [fol. 20] compensation of employees, and (c) gross sales, less returns and allowances, attributable to the San Francisco house bore to the corresponding items of all houses of the Company. It is also agreed that the Franchise Tax Commissioner, in imposing the additional assessment upon the Company, did not give consideration to any other factor or method of allocation. No question exists as to the accuracy of the Commission's calculation, nor respecting the use of the above formulas, if, by reason of the facts stipulated herein, a formula for allocation to California of a portion of the Company's income from all sources is proper. This stipulation is made without prejudice as to any other year than that on which the tax here involved is predicated.

8. In the year 1935 the total sales made by the Company at all houses amounted to $66,326,000, of which $5,206,000 were made from the San Francisco house. The purchases made for the account of the San Francisco house were substantially in the same proportion to total purchases. All purchases made by the Company for sale at its various houses are made through a central buying division. By reason of the volume of purchases made by the Company more favorable prices are obtained than would be obtainable in respect of purchases for the account of any individual house operated by the Company.

[fol. 21] 9. The addition of purchases in an amount equal to the purchases made for the account of the San Francisco house results in no more favorable prices than could be obtainable in respect of purchases in an amount equal to the purchases which would be made by the Company for its other houses if the San Francisco house were not in existence, and a reduction in the volume of purchases in an

amount equal to the purchases made for the San Francisco house would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the Company. The stipulation in this paragraph shall not be deemed an admission by defendant that plaintiff is entitled to segregate the income of its San Francisco house from that of other houses for purposes of computing franchise tax.

10. It is claimed by defendant that by reason of the facts hereinabove set forth the operations of the Company are unitary in character and that the formula for allocation of income used by the Franchise Commissioner was lawful and proper and that the Company is not entitled, for the purpose of determining tax payable under the Bank and Corporation Franchise Tax Act, to use separate accounting of its San Francisco house to determine its net income in the State of California.

11. It is claimed by the Company that its operations are not unitary in character; that its net income reasonably [fol. 22] attributable to the business done within the State of California is the income derived from its San Francisco house alone which resulted in a loss in the year 1935; that the method of allocation used by the Commissioner is not in accordance with the provisions of the Bank and Corporation Franchise Tax Act, and that if said Act is construed as authorizing such method of allocation and assessment, said Act is in violation of the due process clause of the Fourteenth Amendment to the Constitution of the United States.

12. It is agreed that the foregoing facts, in addition to those alleged in the complaint and admitted by the answer, were submitted to and considered by the Franchise Tax Commissioner, and that the assessment of additional tax made by him was predicated entirely upon the theory that as a matter of law the business done by the Company as hereinbefore set forth is a part of a unitary business warranting the application of the method of allocation of the Company's total net income hereinabove described. It is agreed that no other fact or circumstance was considered or used by the Commissioner in making such assessment and that the Court, in determining this case, shall be bound by no inference or presumption in respect of any matter

of fact not herein set forth, and if, despite this stipulation, the Court deems that it is found by any inference or presumption respecting the assessment made by the Commis-
[fol. 23] sioner, or that this stipulation fails to establish any fact necessary to a decision, the case shall be re-opened for the taking of further proofs in respect thereof.

13. The stipulations of fact herein contained are without prejudice to the claim of plaintiff that its earnings in California are solely those derived from operation of its San Francisco house, and that it is taxable in California only in respect of such earnings, without regard to earnings from its operations in other states and without prejudice to the claim of defendant that plaintiff's operations in California are of such a character as to be incapable of segregation from its other operations, and that plaintiff may be taxed on an allocation of its entire net income in the manner done by the defendant.

Dated July 8, 1938.

U. S. Webb, Attorney General, H. H. Linney, Deputy Attorney General, By James J. Arditto, Deputy Attorney General, Attorneys for Defendant. Brobeck, Phleger & Harrison, Attorneys for Plaintiff.

[File endorsement omitted.]

[fol. 24] In Superior Court for City and County of San Francisco

Findings of Fact and Conclusions of Law—Filed October 10, 1938

This cause came on regularly for trial on the 21st day of July, 1938, before the Court sitting without a jury, no jury having been demanded by either party, Messrs. Brobeck, Phleger & Harrison appearing as attorneys for plaintiff, and Messrs. U. S. Webb, H. H. Linney and James J. Arditto appearing as attorneys for defendant; stipulation of facts, signed by counsel for the respective parties was filed and received by the Court, and the cause thereafter argued and submitted;

The Court having considered the evidence and the arguments of the parties, and being fully advised in the premises, now makes its Findings of fact and Conclusions of Law as follows:

FINDINGS OF FACT

1. The Court finds that the facts are as stated in the stipulation of facts on file herein, and said stipulation of facts is hereby adopted as the Findings of Fact of the Court.

And as

CONCLUSIONS OF LAW

therefrom, the Court decides:

1. That the assessment of additional tax made by the Franchise Tax Commissioner of the State of California in [fol. 25] the amount of Three Thousand Seven Hundred Ninety-eight and 43/100ths Dollars ($3,798.43) was duly and regularly made pursuant to the Bank and Corporation Franchise Tax Act;

2. That plaintiffs take nothing by this action.

Let judgment be entered accordingly.
Done in open Court this 7 day of October, 1938.

J. J. Trabucco, Judge of the Superior Court.

[File endorsement omitted.]

IN SUPERIOR COURT FOR CITY AND COUNTY OF SAN FRANCISCO

JUDGMENT—Filed October 10, 1938

This cause came on regularly for trial on the 21st day of July, 1938, before the Court sitting without a jury, no jury having been demanded by either party, Messrs. Brobeck, Phleger & Harrison appearing as attorneys for plaintiff, and Messrs. U. S. Webb, H. H. Linney and James J. Arditto appearing as attorneys for defendant, and a stipulation of facts, signed by the parties, having been filed herein and received by the Court, and the cause thereafter argued and submitted, and the Court having made and signed its Findings of Fact and Conclusions of Law herein and or-

[fol. 26] dered that judgment be entered in accordance therewith;

Now, Therefore, It is Ordered, Adjudged and Decreed that plaintiff Butler Brothers, a corporation, take nothing by its action herein, and that defendant do have and recover from plaintiff his costs herein incurred in the sum of $—.

Done in open Court this 7th day of October, 1938.

J. J. Trabucco, Judge of the Superior Court.

Recorded October 11, 1938, Vol. 445, page 290, Oct. 11, 1938. H. A. van der Zee, Clerk, by C. E. Coghlan, Deputy Clerk.

[File endorsement omitted.]

[fol. 27] Clerk's certificate to judgment roll omitted in printing.

[fol. 28] IN SUPERIOR COURT FOR CITY AND COUNTY OF SAN FRANCISCO

NOTICE OF APPEAL—Filed October 15, 1938

To the clerk of the above-entitled court and to Charles G. Johnson, as Treasurer of the State of California, the defendant herein, and to Messrs. U. S. Webb, H. H. Linney and James J. Arditto, attorneys for said defendant;

You will please take notice that the plaintiff in the above-entitled action hereby appeals to the Supreme Court of the State of California from the judgment entered therein in the said Superior Court on the 11th day of October, 1938, wherein judgment was entered in favor of the defendant and against plaintiff and from the whole thereof.

Dated San Francisco, California, October 14, 1938.

Brobeck, Phleger & Harrison, Attorneys for Plaintiff.

Receipt of a copy of the within Notice of Appeal is hereby admitted this 15th day of October, 1938.

U. S. Webb, Atty. Gen., by James J. Arditto, Deputy.

[File endorsement omitted.]

[fol. 29] IN SUPERIOR COURT FOR CITY AND COUNTY OF SAN FRANCISCO

STIPULATION AS TO TRANSCRIPT ON APPEAL

It is hereby stipulated that the foregoing transcript on appeal is correct; that it contains full, true and correct copies of all the papers therein set forth now on file in the office of the county clerk of the City and County of San Francisco, State of California; that the said foregoing papers shall constitute the transcript on appeal in this cause and that the appeal may be heard and determined thereon.

Dated October 27, 1938.

Brobeck, Phleger & Harrison, Attorneys for Appellant. U. S. Webb, H. H. Linney, Attorneys for Respondent.

[fols. 30-33] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 34] IN SUPREME COURT OF CALIFORNIA

S. F. No. 16157

3 Civ. 6464

BUTLER BROTHERS, a Corporation, Plaintiff and Appellant,

vs.

CHARLES G. JOHNSON, as State Treasurer of the State of California, Defendant and Respondent

MOTION AND ORDER SUBSTITUTING PARTY DEFENDANT—Filed April 22, 1940

Come now Brobeck, Phleger & Harrison, attorneys for plaintiff, and request that pursuant to section 30 of the Bank and Corporation Franchise Tax Act "Charles J. McColgan as Franchise Tax Commissioner of the State of California" be substituted as defendant herein in the place and stead of Charles G. Johnson, as State Treasurer of the State of California.

Dated this 12 day of April, 1940.

Brobeck, Phleger & Harrison, Attorneys for Plaintiff.

Counsel for defendant hereby consent that the order of substitute*d* be made.

Earl Warren, Attorney General; H. H. Linney, Deputy; Valentine Brookes, Deputy.

By the Court:

In the above entitled action, upon motion of the plaintiff, the Attorney General consenting thereto, it is hereby ordered that "Charles J. McColgan, as Franchise Tax Commissioner of the State of California" be and he is hereby substituted as defendant herein in the place and stead of "Charles G. Johnson, State Treasurer of the State of California."

Apr. 22, 1940.

Thompson, Acting P. J.

[File endorsement omitted.]

[fol. 35] In District Court of Appeal of California

San Francisco—J. J. Trabucco, Judge

Civil No. 6464. Third Appellate District

May 18, 1940

101 C. A. D. 612

Butler Brothers (a Corporation), Plaintiff and Appellant,

v.

Charles J. McColgan, as Franchise Tax Commissioner of the State of California, in the Place and Stead of Charles G. Johnson, State Treasurer of the State of California, Defendant and Respondent

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Opinion and Judgment

This action was brought to recover the sum of $4,143.10, being the amount of taxes and interest thereon paid to respondent under protest. Judgment was entered in favor of respondent, and plaintiff appealed therefrom.

The cause was submitted upon an agreed statement of facts which may be summarized as follows:

Plaintiff and appellant, Butler Brothers (herein called "the Company"), is an Illinois corporation, having its principal corporate office at Chicago. It is engaged in the wholesale dry goods and general merchandise business, purchasing from manufacturers and others, and selling to retailers only. It operates seven distinct wholesale houses at Chicago, Jersey City, Baltimore, Minneapolis, St. Louis, Dallas and San Francisco. Each of these houses serves a separate trade territory. At each house stocks of goods are maintained, from which sales are made in its territory. Each handles its own sales, and all solicitation, credit and [fol. 36] collection arrangements in connection therewith, and keeps books of account showing the operations of the house. All sales in California were made from the San Francisco house and all receipts credited thereto.

The greater part of the operating expense of the houses is directly and exclusively incurred at the respective houses, including such items as labor, rentals, etc. There are, however, some common expenses such as executive salaries and corporate overhead and the expense of operating a central buying division and a central advertising division. These expenses are apportioned to the respective houses on bases which, it is agreed, are in accord with recognized accounting practice, and the accuracy and propriety of such bases of apportionment are here conceded. The aggregate of such common expenses so charged to the San Francisco house for the year 1935 was $100,091, of which, it is agreed, approximately 75 per cent would have been incurred whether or not the San Francisco house were operated. Except for such common expenses, each house is operated independently of each other house.

Through a central buying agency goods required for resale in the various houses are ordered, but such goods are shipped directly from the manufacturer to the houses, where the cost thereof, with transportation charges thereon, is entered on the books of the house. No charges are made against any house for the benefit of the company, or any other house by reason of such centralized purchases, but the actual cost of operating the central buying division [fol. 37] is allocated to the houses as stated in the preceding paragraph. By reason of the volume of purchases so

made, more favorable prices are obtained than would be obtainable in respect to purchases for the account of any individual house, but addition or subtraction of purchases in the volume made for the San Francisco house would have no effect on the prices obtainable for the remaining houses.

The accounts of the San Francisco house, computed by deducting from the gross receipts from all sales made therefrom (which includes all sales made and business done in California) the actual cost of merchandise and other direct expenses, and the apportioned share of common expenses previously described, showed for the year 1935 a loss of $82,851. Within the time allowed by law a report showing this loss was made and the minimum tax of $25 was paid for the year 1936. During the year 1935 the operations of all houses of the company produced a profit of $1,149,677. The commissioner subsequently assessed an additional tax of $3,798.43; which, with interest amounting to $344.67, was paid under protest on September 16, 1938. The additional assessment was predicated on the allocation to California of 8.1372 per cent of the company's total income derived from all sources. This percentage was a mathematical average of the percentages which the value of the tangible property, payroll and gross sales attributable to California bore [fol. 38] to the corresponding items of all houses of the company. If an allocation is proper, use of the particular percentage here used is not questioned.

The tax in question was levied under the provisions of section 10 of the Bank and Corporation Franchise Tax Act (General Laws, Act 8488, vol. 2, p. 3851). That section provides:

"If the entire business of the bank or corporation is done within this state, the tax shall be according to, or measured by its entire net income; and if the entire business of such bank or corporation is not done within this state, the tax shall be according to, or measured by that portion thereof which is derived from business done within this state. The portion of net income derived from business done within this state, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, payroll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the state the portion of net income reasonably attributable to the business done within this state and to avoid subjecting the taxpayer to double taxation * * *."

It is contended by appellant that the method by which the tax was fixed and computed was unauthorized and unlawful, and that such method had the effect of taxing plaintiff on, and in respect to income derived from sources be- [fol. 39] yond the jurisdiction of the state. This resulted, it is contended, in a denial of due process of law, and of the equal protection of the law, in violation of the Fourteenth Amendment of the Constitution of the United States.

On the other hand, respondent contends that the tax was levied upon income from business derived from within this state; that such business was unitary in character; and that the state was therefore justified in applying the formula method in arriving at the net income of appellant.

The sole question presented is whether the franchise commissioner should have adopted the separate accounting method in computing the franchise tax, or whether it was proper and legal for him to have used the formula system. If the first method is used, only the minimum tax of $25 would be due. Under the second method, which was actually applied here, the tax amounted to $3,798.43. The first method shows a loss in the California operations of appellant amounting to $82,851. Under the second, respondent showed that appellant enjoyed and received a net income from the business done in California amounting to $95,000. *In respect to net income, the two methods are some $177,851 apart.* Both methods are described in the stipulated facts above. The first is obviously based upon strict and accurate accounting procedure, while the second is the [fol. 40] application of a set formula which has been approved in many jurisdictions in those cases where interstate operations are carried on, and where, from the nature of such operations, income cannot be properly allocated by separate accounting methods. Plain instances which justify the application of the formula method would be telegraph, telephone, railroad and express companies. If there is any evidence to sustain a finding that the operations of appellant in California, during the year 1935, contributed to the net income derived from its entire operations in the United States, it would seem as though the method used was a proper one. Such income would be within the purview of the statute quoted above—"The portion of the net income derived from business done within this state". Where the formula method is adopted by the taxing power, the burden of proof is upon the taxpayer to show that such

method has been applied unreasonably and arbitrarily. (*Hans Rees' Sons* v. *State of North Carolina*, 283 U. S. 123.)

Appellant earnestly contends that the evidence is insufficient to justify the imposition of the formula. It points out that there is nothing in the stipulated facts which would justify a finding that it was doing a unitary business, and even if there were such evidence, the method used operated arbitrarily and unreasonably in respect to appellant's busi- [fol. 41] ness. It is agreed by all parties that the formula of allocation to California of a portion of appellant's income from all sources, is proper, if the facts of the case justify the application of a formula. The question is not whether the formula used is fair and proper, but whether, under the facts here, there should be any allocation at all.

The factual structure of the case is relatively simple. Appellant is engaged in buying merchandise from manufacturers and others, and selling to retailers only. It does no manufacturing. It maintains a central buying division, but goods are shipped directly from the manufacturer to the houses in the several states, where the cost thereof and transportation charges are entered upon the books of the house. Further facts appear in the summary given above.

It is fundamental that jurisdiction to tax is dependent upon jurisdiction of the person or transaction sought to be taxed and that for a state to tax property on transactions beyond its jurisdiction is a denial of due process of law and of the equal protection of the laws. (*Frick* v. *Pennsylvania*, 268 U. S. 473.) Where, however, property located in two or more states derives a value from its unity of use, allocation of the composite value on a fair and reasonable basis will be sustained. The familiar illustration of this principle is in the assessment of railroad [fol. 42] property. (*The Railroad Tax Cases*, 92 U. S. 575.) Referring to a unitary business, "That term is simply descriptive, and primarily means that the concern to which it is applied is carrying on one kind of business—a business, the component parts of which are too closely connected to each other to justify division of separate considerations, as independent units." (*Maxwell* v. *Kent-Coffey Mfg. Co.*, 204 N. C. 365, 168 S. E. 397.) It has further been held that unity of *use* is something more than mere unity of *ownership*. (*Adams Express Co.* v. *Ohio*, 165 U. S. 194-222.) The allocation may be made by the

application of a formula, which is based upon certain factors. The following excerpt from the stipulated facts describes the formula used and the manner of its application:

"In the year 1935, the operations of all houses of the Company produced a profit of $1,149,677. The additional tax assessed by the Franchise Tax Commissioner was predicated on the allocation to California of 8.1372% of the total income of the Company derived from all sources, such percentage having been determined by mathematical average of the percentages which (a) value of real and tangible personal property, (b) wages, salaries, commissions and other compensation of employees, and (c) gross sales, less returns and allowances, attributable to the San Francisco house bore to the corresponding items of all houses of the Company."

[fol. 43] The fact that a corporation does business in more than one state does not necessarily justify the application of a formula to ascertain the tax. In *Hans Rees' Sons* v. *State of North Carolina, supra,* the court held:

"But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one State regardless of the extent to which it may be derived from the conduct of the enterprise in another State."

Where, however, a business is unitary in character, that is, where its separate parts cannot be fairly considered by themselves, and where the whole business in the several states derives a value from the unity of use, allocation of income upon a reasonable formula has been sustained. (*Bass, Ratcliff & Gretton* v. *State Tax Commission,* 266 U. S. 271; *Underwood Typewriter Co.* v. *Chamberlain,* 254 U. S. 113.) Aside from the question as to the propriety of applying a formula here, and paramount over all other considerations, is the question whether or not it reasonably appears that a portion of the total net income of appellant was "derived from business done within this State". (Sec. 10 of Act 8488—fully quoted above.)

[fol. 44] The only factor called to our attention by respondent which might point to a unitary business is the

central buying power exercised by the headquarters of appellant in Illinois. The state argues that even though the California house lost money during the year 1935, the operations conducted during that year actually brought a profit to the corporation. They contend that the disposal of some $5,000,000 worth of merchandise during the time mentioned, increased the purchasing power of appellant, and thus permitted it to buy for its other houses, through volume purchases, at a price lower than it otherwise would have secured. It appears, however, that the parties have stipulated otherwise. We quote from the agreed facts: "A reduction in the volume of purchases made for the San Francisco house would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the Company."

Most of the cases cited by respondent, with one exception, involve corporations which are engaged in *manufacturing*. In those instances a manufacturing profit was made by the corporation before the merchandise was shipped to another state. This is true of the Underwood case, supra. Here, none of the merchandise was manufactured by appellant. It was engaged solely in buying and selling. There are cases where a corporation engaged in buying and selling has been held subject to the payment of income taxes in [fol. 45] one of the states where it has been doing business. In *International Elevator Co.* v. *Thoresen*, 58 N. D. 776, 228 N. W. 192, a company which bought and sold grain was held liable for the payment of an income tax in the state of North Dakota. It bought grain in that state and shipped it for resale in other states. The corporation filed a return showing only income derived from sales in North Dakota. It failed to account for sales outside the state, and contended that only transactions within the state should be considered in fixing its income. It showed that it had lost some $85,000 on transactions *within the state*. Its net profit from all its operations in several states amounted to $249,515.11. A tax of $2,937.98, computed by a formula, was upheld. The case was clearly one where a separate accounting system did not disclose the income received from shipment and sale of grain outside the state. The return by the elevator company included only income received from sales at North Dakota elevators. The case of *Montgomery Ward & Co.* v. *Kansas Tax Commission*,

151 Kan. 159, 98 Pac. (2d) 143, throws little light upon the question. No attempt was there made by the state to base a tax upon the net income of the corporation outside the state of Kansas. The only question was whether or not the corporation was entitled to charge against its Kansas income a proportionate share of certain expenses in- [fol. 46] curred outside the state. The court held in the affirmative.

Appellant relies strongly upon the case of *Standard Oil Co.* v. *Wisconsin Tax Commission*, 223 N. W. 85. Wisconsin taxes corporations on a basis very similar to our Bank and Corporation Franchise Tax Act and provides for allocation of income in a manner very like section 10. A company engaged in the production, refining and sale of petroleum products but engaged only in selling within Wisconsin was taxed on the basis of a statutory allocation of income from the entire operation. In that case it was shown that accurate accounting of the operations of the various branches existed. The court there held:

"In the enactment of the statute relating to the allocation of income of persons doing business within and without the State, the declared legislative purpose is to make a reasonable and equitable distribution of the taxpayer's income to the end that that part of the income justly assessable in the State of Wisconsin may be ascertained. The statute does not enjoin upon the Commission the use of that method which will produce the largest amount of taxable income but rather that method which will most justly apportion the income properly taxable in Wisconsin. Here it appears conclusively that it is possible to ascertain the income derived from business transactions in Wisconsin by the application of proper accounting methods. • • • There [fols. 47-48] are some operations which from their very nature produce an income which cannot be properly allocated by separate accounting methods, instances of which are the telegraph, telephone and express companies. They stand ready to serve whoever may apply for service and the entire operation constitutes a unit of service. *That is not the case with the manufacturing and sales business, particularly so where the accounts are so kept as to be readily separable.*"

We regard the foregoing case as very persuasive authority to the effect that a separate accounting method should be applied in the instant case.

We therefore conclude that the stipulated facts show that the company actually incurred a loss in California; that its California earnings could have been accurately ascertained without the necessity of recourse to any arbitrary formula, and that the use of such formula results in the imposition of a tax on income not earned in California, and therefore not subject to its taxing power.

The facts found do not support the judgment, and it is ordered that the judgment be reversed, with directions to the trial court to enter judgment in favor of appellant.

Tuttle, J.

We concur:
Pullen, P. J.
Thompson, J.

[fol. 49] IN SUPREME COURT OF CALIFORNIA, IN BANK

S. F. No. 16157

BUTLER BROTHERS, a Corporation, Plaintiff and Appellant,

vs.

CHARLES J. McCOLGAN, As Franchise Tax Commissioner of the State of California, Defendant and Respondent

OPINION—Filed March 21, 1941

This action was brought to recover an additional assessment made by the defendant as Franchise Tax Commissioner under authority of the Bank and Corporation Franchise Tax Act (Statutes 1929, Ch. 13, as amended) for the taxable year 1936, based upon income for the year 1935, paid by plaintiff under protest. Judgment was entered in favor of defendant, and plaintiff appealed therefrom.

The cause was submitted upon an agreed statement of facts, which may be summarized as follows:

Plaintiff, Butler Brothers (herein called "the Company"), is an Illinois corporation, having its principal corporate office at Chicago. It is engaged in the wholesale dry goods and general merchandise business, purchasing from manufacturers and others and selling to retailers only. It operates seven wholesale distributing houses at Chicago,

Jersey City, Baltimore, Minneapolis, St. Louis, Dallas and San Francisco. Each of these houses serves a separate trade territory. At each house stocks of goods are maintained, from which sales are made in its territory. Each house handles its own sales, and all solicitation, credit and [fol. 50] collection arrangements in connection therewith, and keeps books of account showing the operations of the house. All sales in California were made from the San Francisco house and all receipts credited thereto.

Part of the operating expense of the houses is directly and exclusively incurred at the respective houses, including such items as labor, rentals, etc. The remainder consists of certain items of common expense such as executive salaries and corporate overhead and the expense of operating a central buying division and a central advertising division. These expenses are allocated to the respective houses on bases which, it is agreed, are in accord with recognized accounting practice, and the accuracy and propriety of such bases of apportionment are here conceded. For the year 1935 the amount of such allocated expense charged to the San Francisco house was $100,091, of which, it is agreed, approximately seventy-five per cent would have been incurred even though the San Francisco house was not operated. Except for such common expenses, each house is operated independently of each other house.

The company maintains a central buying division through which goods for resale are ordered, but such goods are shipped by the manufacturers to the houses for which ordered, where the cost thereof and the transportation charges thereon are entered on the books of the house. No charges are made against any house for the benefit of the company, or any other house by reason of such centralized purchasing, but the actual cost of operating the central buying division is allocated to the houses, as stated in the preceding paragraph. By reason of the volume of purchases made by the company more favorable prices are obtained than would be obtainable in respect of purchases for the account of any individual house, but addition or reduction in the volume of purchases in an amount equal to the purchases made for the account of the San Francisco house would have no effect on the prices obtainable for the remaining houses.

The company computed its income from the operation of [fol. 51] the San Francisco house by deducting from the

gross receipts from sales of merchandise in California the costs of such merchandise, the direct expenses of the San Francisco house, and the apportioned share of common expenses previously described. According to this computation the San Francisco house operated at a loss of $82,851 for the year 1935. Within the time allowed by law a report showing this loss was made and the minimum tax of $25 was paid for the year 1936. In the year 1935 the operations of all houses of the company produced a profit of $1,149,677. The Franchise Tax Commissioner subsequently assessed an additional tax of $3,798.43, which, with interest amounting to $344.67, was paid under protest on September 16, 1938. The additional assessment was predicated on the allocation to California of 8.1372% of the total income of the company derived from all sources, such percentage having been determined by mathematical average of the percentages which the value of the tangible property, payroll and gross sales attributable to California bore to the corresponding items of all houses of the company. If an allocation is proper, use of the particular percentage here is not questioned.

The tax in question was levied under the provisions of section 10 of the Bank and Corporation Franchise Tax Act (General Laws, Act 8488, Vol. 2, p. 3858; Stats. 1929, p. 19; amended by Stats. 1931, p. 2226; Stats. 1935, p. 965), which, so far as here involved, reads as follows:

"If the entire business of the bank or corporation is done within this State, the tax shall be according to or measured by its entire net income; and if the entire business of such bank or corporation is not done within this State, the tax shall be according to or measured by that portion thereof which is derived from business done within this State. The portion of net income derived from business done within this State, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, pay roll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation."

[fol. 52] It is claimed by appellant that the method by which the tax was fixed and computed was unauthorized

and unlawful, and that such method had the effect of taxing plaintiff on and in respect to income derived from sources beyond the jurisdiction of the state. This resulted, it is contended, in a denial of due process of law and of the equal protection of the law, in violation of the Fourteenth Amendment of the Constitution of the United States.

On the other hand, respondent contends that the tax was levied upon income from business derived from within this state, that the operations of the company are unitary in character, and that the formula for allocation of income used by the Franchise Tax Commissioner was lawful and proper in arriving at the net income of appellant from business done in California—computed to be approximately $95,000.

The sole question to be determined on this appeal is whether it is lawful and proper for the respondent, as Franchise Tax Commissioner, to insist upon use of the formula for allocation of income in a case such as this, or whether the company is entitled to use the separate accounting of its San Francisco house to determine its net income in the State of California. The answer to this question depends entirely on the nature of the business conducted within and without the state by appellant, a foreign corporation. It is only if its business within this state is truly separate and distinct from its business without this state, so that the segregation of income may be made clearly and accurately, that the separate accounting method may properly be used. Where, however, interstate operations are carried on and that portion of the corporation's business done within the state cannot be clearly segregated from that done outside the state, the unit rule of assessment is employed as a device for allocating to the state for taxation its fair share of the taxable values of the taxpayer (Adams Express Co. v. Ohio State Auditor, 165 U. S. 194, 166 U. S. 185, 17 S. Ct. 604; Pullman's Palace Car Com-[fol. 53] pany v. Pennsylvania, 141 U. S. 18, 11 S. Ct. 876; State Railroad Tax Cases, 92 U. S. 575, 23 L. Ed. 663). In the early cases in which the unit rule first made its hesitating appearance there was always a physical link, a palpable unity of substance, a binding together by a system of rails or by telegraph wires. (State Railroad Tax Cases (1875), supra; Western Union Telegraph Co. v. Taggart (1896), 163 U. S. 1, 16 S. Ct, 1054, 41 L. Ed. 49). Then in Adams Express Co. v. Ohio State Auditor (1897), supra,

the standard unity of substance was openly replaced by one of unity of use and management. This decision clearly recognized that in assessing tangible property for taxation, its value producing qualities in connection with other pieces of tangible property outside the state must be considered. If there is any evidence to sustain a finding that the operations of appellant in California during the year 1935 contributed to the net income derived from its entire operations in the United States, then the entire business of appellant is so clearly unitary as to require a fair system of apportionment by the formula method in order to prevent overtaxation to the corporation or undertaxation by the state. (Underwood Typewriter Co. v. Chamberlain, 254 U. S. 113, 41 S. Ct. 45). Such income would be within the purview of the statute quoted above—"The portion of the net income derived from business done within this State".

Preliminary to analysis and discussion of the cases cited by the parties as bearing on the issue involved in the instant case, we shall review briefly the relatively simple factual structure as it is logically reflected in the modus operandi of appellant's business. The company is engaged in buying merchandise from manufacturers and selling to retailers only. It maintains a central buying department outside the state. By its large scale purchasing activity, appellant concededly is able to buy at lower prices than would otherwise be possible, thus realizing a purchasing saving. But it is able to buy in large quantities only because it is able to sell in large quantities, so that it is apparent that the [fol. 54] purchasing saving is made possible only because of the sales. Furthermore, it is pertinent to observe that the saving is not turned into profit until the sales are made. Thus, the purchasing activities and the sales activities are interdependent and supplement one another to form one single, unitary business. Appellant here calls attention to the fact that the parties stipulated that if an amount of sales equal to those of the San Francisco store were eliminated, the volume would not be reduced enough to affect the price at which appellant bought. On this ground appellant urges that the San Francisco store is the one which does not affect purchase price differentials. But, as respondent urges, it also should be noted that it was stipulated that appellant bought at lower prices because of the great volume it obtained through having several stores. The weakness of appellant's argument is readily apparent

when pursued to its logical conclusion. If the omission of the California sales would have no effect on the purchasing power, the omission of sales in an equal amount wherever made would likewise have no effect on the company's ability to purchase at a saving. Thus, by proceeding in turn from state to state, it could be shown that none of the sales in any of the states should be credited with the income resulting from the purchasing of goods in large quantities. It is our opinion that the sales made in each of the seven states in which appellant does business must be proportionately credited with the profits resulting from the purchasing power which such sales in the aggregate produce. Other salient factors indicating the unitary character of appellant's business are the central advertising division and the central accounting and management division. The former enables appellant to spread its advertising cost over more stores and units and to secure its advertising at a lower cost per unit, thereby making possible advertising opportunities unavailable to a single store; as to the latter (central accounting and management department), the vol- [fol. 55] ume of business resulting from operation of the company's several stores permits better as well as more costly services of accounting and management to be available to each store, whereas if each were separately operated, services of such quality in all probability would be too expensive to be practicable.

The Supreme Court of the United States has repeatedly held that companies whose income has resulted from a series of transactions beginning with manufacture in one state and sales in another were unitary businesses. (Underwood Typewriter Co. v. Chamberlain (1920), 254 U. S. 113, 41 S. Ct. 45, 65 L. Ed. 165; Bass, Ratcliff & Gretton, Ltd., v. State Tax Commission (1924), 266 U. S. 271, 45 S. Ct. 82, 69 L. Ed. 282). While it is not clear from the record whether appellant manufactured any of its goods in the State of Illinois or elsewhere, it is conceded that appellant purchased most of its goods through the Illinois central purchasing arrangement. This central purchasing factor is completely analogous and comparable to the manufacturing activities in the Underwood Typewriter and Bass Ale cases, supra, wherein we find recognition of the principle that income from sales is attributable to the series of transactions from which the income is derived. Since these two leading cases involve the validity of allocation by applying

a percentage formula to the entire income in order to determine the income taxable in a state where the business is only partly carried on, we shall consider them in some detail.

In Underwood Typewriter Co. v. Chamberlain, supra, the company manufactured its typewriters in Connecticut and sold them generally throughout the country. Using a statutory method of allocation (by assigning to the state that portion of the total income which the value of real and tangible personal property within the state bore to the total value of such property within and without the state), Connecticut determined that 47 per cent of the company's net income was derived from property and transactions within the state. The company objected to the method of [fol. 56] apportionment on the ground that only a little over 3 per cent of its net receipts was collected in Connecticut. The court upheld the Connecticut allocation for the reasons expressed in the following excerpt from the opinion at pages 120-121:

"• • • The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States. In this it was typical of a large part of the manufacturing business conducted in the State. The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a method of apportionment which, for all that appears in this record, reached, and was meant to reach, only the profits earned within the State. 'The plaintiff's argument on this branch of the case,' as stated by the Supreme Court of Errors, 'carries the burden of showing that 47 per cent of its net income is not reasonably attributable, for purposes of taxation, to the manufacture of products from the sale of which 80 per cent of its gross earnings was derived after paying manufacturing costs.' The corporation has not even attempted to show this; and for aught that appears the percentage of net profit earned in Connecticut may have been much larger than 47 per cent. There is, consequently, nothing in this record to show that the method of apportionment adopted by the State was inherently arbitrary, or that its application to this corporation produced an unreasonable result."

Here we have clear and concise expression of the only limitation on the use of a formula in the allocation or apportionment of income of a unitary business, to-wit, the formula must not be intrinsically arbitrary, and it must not produce an unreasonable result.

Bass, Ratcliff & Gretton, Ltd., v. State Tax Commission, supra, involved a British corporation engaged in brewing and selling Bass' ale. Its brewing was done and a large part of its sales were made in England, but it had imported a portion of its product into the United States, which it sold in branch offices maintained in New York and Chicago. During the income year in question, the entire business was operated at a substantial profit, but the company, for federal income tax purposes, reported no income for that year from its business within the United States. Presumably this result was reached by computing its income under the sepa- [fol. 57] rate accounting method. The Tax Commission of the State of New York assigned to New York that portion of the total net income which the value of certain specified classes of assets within New York bore to the total value of such assets within and without the state. The company resisted the tax on the ground that it derived no income from New York and that the action of the Commission was an attempt to assign to New York a portion of the company's income derived from business carried on outside the United States. The court, however, upheld the action of the Commission and at page 282 of its opinion expressed its views regarding the allocation of income of unitary businesses as follows:

"So in the present case we are of the opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places—the process of manufacturing resulting in no profits until it ends in sales—the State was justified in attributing to New York a just proportion of the profits earned by the Company from such unitary business. In Wallace v. Hines, 253 U. S. 66, 69, it was recognized that a State, in imposing an excise tax upon foreign corporations in respect to doing business within the State, may look to the property of such corporations beyond its borders to 'get the true value of the things within it, when they are part of an organic

system of wide extent,' giving the local property a value above that which it would otherwise possess, and may therefore take into account property situated elsewhere when it 'can be seen in some plain and fairly intelligible way that it adds to the value of the (property) and the rights exercised in the State.' This is directly applicable to the carrying on of a unitary business of manufacture and sale partly within and partly without the State."

Thus, it is apparent from the language of this case that with respect to a unitary business, income from the taxing state as determined by an allocation formula was controlling, where the statutory method of apportionment was not shown to be arbitrary or unreasonable.

In support of its argument that respondent's application of the formula would tax income from transactions taking place beyond the jurisdiction of California, appellant relies heavily upon Hans Rees' Sons v. State of North Carolina (1931), 283 U. S. 123, 51 S. Ct. 385, 75 L. Ed. 879. [fol. 58] But an examination of the facts and legal principles involved therein reveals that there is nothing in that decision to support appellant's argument. The corporation was engaged in the business of tanning, manufacturing and selling leather products, and its principal manufacturing and supply house was located in North Carolina. Extensive sales and purchasing activities were carried on outside the state. The corporation offered proof which tended to show that for the years in question the average income having its source within the state was but 17 per cent of the total and actually showing that the percentage of its income attributable to North Carolina did not in any event exceed 21.7 per cent of the total, whereas the statutory formula, restricted to tangible property, had allocated to North Carolina approximately 89 per cent of the income. The opinion clearly recognized the necessity of using a method of apportioning to a state that portion of entire income which is "reasonably attributable to the processes conducted within the borders of that State," but because the particular statutory formula employed, consisting simply of the property factor, attributed to North Carolina a percentage of income "out of all appropriate proportion to the business transacted by the appellant in that State," the court refused to approve the result reached by the formula. Careful analysis of the underlying legal principles considered

in the Hans Rees' case compels us to conclude that it, like the Underwood Typewriter and Bass Ale cases, supra, recognized that where a business is unitary in character, so that its separate parts cannot be fairly considered by themselves and the whole business in the several states derives a value from the unity of use, allocation of income upon a reasonable formula is properly sustained.

The latest expression of the Supreme Court of the United States on this subject brought to our attention is North American Cement Corporation v. Graves (1936), 269 N. Y. 507, 199 N. E. 510; 243 App. Div. 834, 278 N. Y. S. 920; 299 U. S. 517, 57 S. Ct. 311, wherein it is significant to note [fol. 59] that Bass, Ratcliff & Gretton, Ltd., vs. State Tax Commission, supra, was cited in support of its holding that income from the taxing state as determined by an allocation formula was controlling, although the taxpayer showed that by separate accounting much less income would be allocated to the taxing state. The United States Supreme Court and the New York Courts from which the taxpayer appealed all decided the case with memorandum opinions, so the facts must be obtained from the record in the case (Volume 2253, United States Supreme Court Records). The taxpayer, a foreign corporation, owned and operated three cement plants and one lime plant and sold the products thereof. Two of the cement plants were in New York, one was in Maryland and the lime plant was in West Virginia. The corporation operated its four plants separately and sold their products in separate districts, kept separate accounts for them, and sold very little of the output of the West Virginia and Maryland plants in New York. The Tax Commission allocated the net income of the corporation by a one factor formula (property factor) for the income years 1925, 1926, 1927 and 1929. By this means large incomes were allocated to New York for each of those years. The corporation, by an elaborate separate accounting system, showed that for 1925 the New York income was much less than that allocated to that state by the formula, and that for 1926, 1927 and 1929 the corporation sustained large losses from its New York business instead of deriving from New York the income allocated to it by the formula. In the face of this evidence the Supreme Court of the United States, affirming the New York Court of Appeals and Appellate Division, Supreme Court, held that the results of the formula were controlling and upheld the assessment thereon.

The significance of this decision on two points involved in the instant case is readily apparent: (1) it holds that the operations of four separate manufacturing plants, one of them making a different product from different materials [fol. 60] than the others, are so interrelated as properly to be treated as *unitary;* (2) it holds that separate accounting in accordance with recognized accounting practice is insufficient evidence to disprove the propriety and presumption of fairness of formula allocation. On both points this decision is contrary to Standard Oil Co. v. Wisconsin Tax Comm. (1929), 197 Wis. 630, 223 N. W. 85, on which appellant strongly relies in asserting that the results of its separate accounting must be accepted by respondent as tax administrator. However, careful examination of the factual situation in this Wisconsin case reveals a peculiar distinguishing allocation factor which undoubtedly exerted a strong influence on the result reached by the court there.

In Standard Oil Co. v. Wisconsin Tax Comm., supra, the plaintiff company produced, refined, transported and marketed petroleum products in eleven mid-western states, and its property within Wisconsin consisted principally of tanks and filling stations required to supply the Wisconsin demand. Fifty-four per cent of the oil stored in these tank farms was sold to Wisconsin and forty-six per cent without the state. Plaintiff company did practically no manufacturing in Wisconsin. The controversy arose as to the manner in which that part of its income properly taxable in the state of Wisconsin should be ascertained. The Tax Commission used a ratio method provided in the statute for unitary business transactions conducted within and without the state. The company contended that its income should be ascertained by the allocation and separate accounting method by which the Wisconsin business was charged *at the market price* with all products received by it, with the expense of transacting the business, including a proper allocation of general or overhead expenses and office accounting, that there should be credited to Wisconsin the gross amount received from sales of goods within the state, and that the difference constituted the taxable income of plaintiff company. The court upheld the plaintiff company's contentions. [fol. 61] The distinction to be noted here differentiating this Wisconsin situation from the instant case is the fact that the products furnished to the Wisconsin business were charged at "*market value*" rather than at cost. *Market*

value (at wholesale) included reasonable *profit*, and such profit became income to the company in the outside states. This amounted in effect to allocation of income as between Wisconsin and the other states. That the plaintiff company's arbitrary method of assigning a fictitious market value at which the selling division was deemed to have "bought" the oil from the refining division greatly impressed the Wisconsin court and furnished reason for its distinction of the Underwood Typewriter case, supra, appears from the following language at page 639 of the opinion: "Nor do we find anything in Underwood Typewriter Company v. Chamberlain, 254 U. S. 113, 41 S. Ct. 45, inconsistent with our conclusion in this case. There, there was no separation on the basis of market value between the operations of the manufacturing department and the sales department as there is in this case. We perceive no reason why, under the facts in this case, the profits derived from the sales operations should not be ascertained, so far as plaintiff is concerned, as they would be if the sales operations were conducted by a separate corporate entity." Whether the Wisconsin court by its decision placed too much emphasis on the value of fictions is not our concern here; suffice it to say that the Wisconsin court manifestly sanctioned the practice of charging the products to the Wisconsin end of the business at *wholesale market prices* in determining income derived in Wisconsin. The distinction between *market price* and *cost* cannot be ignored; the former includes profits and the latter does not; and it is this differentiation which decidedly limits the applicability of the Wisconsin case to the instant factual situation.

The unitary character of the buying and selling business has been recognized in International Elevator Co. v. Thoresen (1929), 58 N. Dak. 776, 228 N. W. 192, and Great Atlantic & Pacific Tea Co. v. Grosjean (1937), 301 U. S. [fol. 62] 412, 57 S. Ct. 772, 81 L. Ed. 1193. In the Thoresen case, supra, plaintiff company operated a line of grain elevators, about half of which were in Montana and the other half in North Dakota. The company's income was derived chiefly from the sale, outside the state, of grain bought within North Dakota, and the question was whether North Dakota could assess a tax upon any part of the income from the sales outside the state. Like appellant here, the plaintiff company there tried to apportion its income by separate accounting. That procedure was held

improper and allocation of income was sanctioned to North Dakota wholly out of proportion to the receipts within North Dakota. On the mere basis of accounting figures the instant case is less extreme than the North Dakota case, where the net income allocated to the taxing state by the formula exceeded the gross income allocated to the state by separate accounting; yet, in such situation because of the unitary nature of the business, the Supreme Court of North Dakota held that the transactions of buying constituted an essential part of the transactions from which the income collected outside the state was derived.

The Great Atlantic & Pacific Tea Co. case, supra, dealing with a state chain store tax act, bears on the instant issue in that it was there held that the out-of-state stores and central buying and advertising of the buying and selling corporation gave the within-the-state stores advantages which they otherwise would not have had and justified a chain store tax on the within-the-state stores which would otherwise have been, from a constitutional viewpoint, discriminatory. The manifest parallelism between that case and the instant one needs no other comment than the observation that the decision of validity in that case is based on the same reason as that for treating business as unitary in allocating income.

The formula method of allocating or apportioning income in the case of a unitary business was approved by this court in Matson Navigation Co. v. State Board of Equalization, 3 Cal. (2d) 1; affirmed 297 U. S. 728; 56 S. Ct. 553, [fol. 63] 80 L. Ed. 1010. In that case it was established that the power of California to tax foreign corporations measured by their net income and the provisions of section 10 of the Bank and Corporation Franchise Tax Act are co-extensive in scope, and in this connection this court there held that section 10 measures the tax by income from C .fornia and excludes from the measure "income from business done entirely outside the State • • •" (3 Cal. (2d) 1, 8.) In such case as the instant one, allocation of income to the various states in which the business is done by means of a formula that gives weight to the various factors such as property, services of employees and sales, which are responsible for the earning of income, appears entirely reasonable. To rebut the presumption that the formula produced a fair result, "the burden is on the taxpayer to make oppression manifest by clear, cogent evi-

dence." (Norfolk & Western Ry. Co. v. Maxwell (1936), 297 U. S. 682, 688, 56 S. Ct. 625.) In considering the implications of the formula in the last-mentioned case, the Supreme Court of the United States, speaking through Mr. Justice Cardozo, also said at page 688: "* * * a taxpayer does not escape the application of the statute by evidence directed to only one of the related terms. The evidence to be effective must be directed to each of them alike, for only thus can the assumed relation between them be proved to be unreal. * * *" In the case at bar appellant has not furnished any explanation of why its California business differs so from the average that the formula produced an erroneous result. Here there has been only an assertion that a loss incurred in this state. As appellant has failed to show a variance from normal in either the California sales, property or payroll, or in either expenses or revenue, it is our conclusion that appellant has not upheld its burden of proof, for in order to overthrow a formula the taxpayer must introduce such evidence and the [fol. 64] evidence must go to each element of the formula equation. (Norfolk & Western Ry. Co. v. Maxwell, supra.)

In accordance with the foregoing analysis it is our opinion that the unitary nature of appellant's business is definitely established by the presence of the following circumstances: (1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in its centralized executive force and general system of operation. The reasonable and equitable character of this state's formula, based on factors properly reflecting the relative contribution of the activities in the various states to the production of the total unitary income so as not to contravene the restrictions implicit in the Fourteenth Amendment against taxing property outside the state, was recognized in Matson Navigation Co. v. State Board of Equalization, supra. Accordingly, respondent correctly applied the formula method of apportionment to determine California's portion of appellant's income from the business carried on within and without the state.

Judgment affirmed.

Curtis, J.

We concur: Gibson, C. J. Shenk, J., Carter, J.

Traynor, J., took no part in the consideration or decision of this case.

[fols. 65-68] IN SUPREME COURT OF CALIFORNIA. BANK

San Francisco. No. 16157

BUTLER BROTHERS (A Corp.), Appellant,

vs.

CHARLES J. McCOLGAN, as Franchise Tax Commissioner, etc., Respondent

On Appeal from the Superior Court in and for the City and County of San Francisco

JUDGMENT—March 21, 1941

The above entitled cause having been heretofore fully argued, and submitted and taken under advisement, and all and singular the law and premises having been fully considered,

It Is Ordered, Adjudged, and Decreed by the Court that the Judgment of the Superior Court in and for the City and County of San Francisco in the above entitled cause, be and the same is hereby affirmed. Respondent to recover costs on appeal.

Clerk's Certificate to foregoing paper omitted in printing.

[fols. 69-91] IN SUPREME COURT OF CALIFORNIA

[Title omitted]

PETITION FOR REHEARING—Filed April 9, 1941

To the Honorable Phil S. Gibson, Chief Justice, and to the Associate Justices of the Supreme Court of the State of California:

Appellant above named respectfully prays that a rehearing be granted in the above entitled cause.

[fol. 92] The Decision Is Based on Inferences or Presumptions Which It Was Stipulated Should Not Be Made

Finally, at page 15 of the opinion, it is said:

"In the case at bar Appellant has not furnished any explanation of why its California business differs so from

the average that the formula produced an erroneous result. Here there has been only an assertion that a loss incurred in this state,"

[fol. 93] and *Norfolk & Western R. Co. v. Maxwell*, 297 U. S. 682, is cited in support of the proposition that it is incumbent upon a taxpayer questioning a formula to show the inapplicability of all parts thereof. The question here is wholly *distinct from* that in the *Norfolk & Western* case where both income and expense were allocated to the state on a formula basis. The opinion in that case points out:

"For all that appears in the case developed by the Railway, actual gross revenues in North Carolina may have been so far in excess of average gross revenues computed under the statute as to neutralize the discrepancy between actual and average costs of operation. If such a counterbalance exists, appellant has not been injured through the application of the formula."

Here, both income and expense in California are shown by the stipulation. The Company has shown, not "asserted", its income and its expense of the California business, and the facts in this respect are stipulated by the Commissioner, and recognized by this Court in its statement of the case (pp. 2 and 3 of the decision).

It appears that this Court has drawn inferences and presumptions against the Company because of failure to show the reasons why the California income differs from that of other houses. It also appears (pages 6 and 7 of the opinion) that other inferences are drawn regarding the nature and [fol. 94] effect of the advertising and managerial services performed in Illinois for all the houses. We submit that the Court has improperly drawn such inferences, contrary to the stipulation under which this case was submitted (R. 20). It was there agreed that only the stipulated facts were considered by the Commission, and that the Court should indulge no inferences or presumptions as to any matter of fact not set forth in the stipulation. It was further agreed that if notwithstanding this stipulation the Court should deem itself bound to any inferences or presumptions as to matters not covered by the stipulation the matter should be remanded for further hearing.

If any inferences or presumptions are to be indulged by the Court in respect of these matters, we submit that an in-

justice will be done the Company in that such inferences are contrary to facts which, if deemed material, can be shown by the Company, and that if these matters are considered significant the cause should be remanded for further hearing in the trial court. If the cause is so remanded, the Company is prepared and hereby offers to prove:

1. That the San Francisco house was established in 1928;

2. That following such establishment it was necessary to attempt to build up the business in the territory served thereby;

[fol. 95] 3. That the economic depression which had its inception in 1929 occurred before the business was well established and substantially curtailed the business of the house;

4. That such depression continued into the year 1933, and that the volume of business handled by the San Francisco house throughout this period was inadequate to permit operation at a profit;

5. That more or less continuously from 1934 to the present date the Company's operations have been peculiarly harassed by labor difficulties, not only those occurring in the Company's plant, but those which have interrupted and for considerable periods of time wholly suspended water transportation, resulting in increased costs of operation not only in the form of higher wages and transportation charges than were incurred at other houses, but also by reason of labor inefficiency, slowdowns and similar impediments;

6. That as a result of these conditions, costs of operation at the San Francisco house have been substantially in excess of similar costs incurred at many of the other houses of the Company where profitable operations were conducted;

7. That the volume of business transacted through the [fol. 96-99] San Francisco house is much less than in other houses from which a profit is derived, resulting in higher unit costs and less profitable operations;

8. That the so-called advertising of the Company consists solely in the preparation of catalogues and their distribution to retailers with whom the Company does or seeks to do business, and that no advertising advantages other than cer-

tain economies of preparation exist by reason of the presence of seven houses.

* * * * * * *

[fol. 100] IN SUPREME COURT OF CALIFORNIA. IN BANK

[Title omitted]

ORDER DENYING REHEARING—Filed April 17, 1941

By the Court.

Appellant's petition for a rehearing is Denied.

Traynor, J. took no part in the consideration or decision of this matter.

Gibson, Chief Justice.

Dated April 17, 1941.

[File endorsement omitted.]

[fol. 101] [File endorsement omitted]

IN SUPREME COURT OF THE UNITED STATES, OCTOBER TERM, 1941

[Title omitted]

Petition for Appeal, Assignments of Error and Prayer for Reversal—Filed June 28, 1941

PETITION FOR APPEAL

Considering itself aggrieved by the final decision of the Supreme Court of the State of California in the above entitled cause, the plaintiff in said cause, Butler Brothers, a corporation, hereby prays that an appeal be allowed to the Supreme Court of the United States in said cause, and that an order be made fixing the amount of cost bond thereon:

ASSIGNMENTS OF ERROR

And the said Butler Brothers makes the following assignments of error:

That the Supreme Court of the State of California erred in rendering its said decision, affirming the judgment of

the Superior Court of the State of California in and for [fol. 102] the City and County of San Francisco, the court of first instance in said cause, in each of the respects hereinafter stated:

1. In holding that the California Bank and Corporation Franchise Tax Act, California Statutes of 1929, page 19, as amended, did not deprive Petitioner of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

2. In holding that said Act did not impose a tax on income of Petitioner earned and derived from sources wholly outside of the State of California, thus depriving Petitioner of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

3. In holding that said Act did not deprive Petitioner of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States, although said Act as construed by said Court levied a tax upon a percentage of Petitioner's net income allocated to the State of California by an arbitrary allocation formula (based upon a comparison of Petitioner's property, payroll and sales within California as compared to Petitioner's total payroll, property and sales), in spite of the fact that Petitioner's operations in the State of California were conducted at a loss of $82,851 and Petitioner in fact earned no net income from its operations within the State of California and derived no net income from sources within the State of California.

4. In holding that although in fact Petitioner's operations within the State of California resulted in a loss of [fol. 103] $82,851, it was nevertheless subject to a tax on an assumed net income of more than $90,000 by application of the formula prescribed by said Bank and Corporation Franchise Tax Act as amended, and in holding that said Act in imposing such tax did not deprive appellant of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

5. In holding that Petitioner's business, although it consists only of buying and selling merchandise, is a "unitary"

business; in holding that in the case of a unitary business the Bank and Corporation Franchise Tax Act imposes a tax based on a formula allocation of income regardless of an actual loss incurred on business done in California, and in holding that said Act in so imposing such tax does not deprive appellant of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

6. In deciding this case by indulging in inferences and presumptions contrary to the provisions of paragraph 12 of the stipulation of facts upon which this case was tried.

PRAYER FOR REVERSAL

For which errors the Petitioner, Butler Brothers, prays that the judgment of the Supreme Court of the State of California, dated March 21, 1941, in the above entitled cause be reversed and a judgment be rendered in favor of Petitioner, and that Petitioner be awarded its costs.

Leland K. Neeves, James S. Moore, Jr., Attorneys for Appellant Butler Brothers.

Scott, MacGeish & Falk; Brobeck, Phleger & Harrison, of Counsel.

[fol. 104] [File endorsement omitted]

IN SUPREME COURT OF THE UNITED STATES

October Term, 1941

[Title omitted]

ORDER ALLOWING APPEAL—Filed June 28, 1941

Butler Brothers, the appellant in the above entitled cause, having prayed for an order allowing an appeal in said cause to the Supreme Court of the United States from the judgment made and entered in said cause by the Supreme Court of the State of California on the 21st day of March, 1941, and from each and every part thereof, and having presented its petition for appeal, assignments of error and prayer for reversal, together with its statement as to the jurisdiction of the Supreme Court of the United

States on appeal, pursuant to the statutes and rules of the Supreme Court of the United States in such cases made and provided, and the decision of the Supreme Court of the State of California in said cause having been in favor of the validity of the Bank and Corporation Franchise Tax Act of the State of California under the Constitution of the United States, the validity of said Act having been [fol. 105] drawn in question in said cause upon the ground of its being repugnant to the Constitution of the United States,

It is hereby ordered that an appeal be, and the same hereby is, allowed to the Supreme Court of the United States from the Supreme Court of the State of California in the above entitled cause, as provided by law;

And it is further ordered that the Clerk of the Supreme Court of the State of Calif nia shall prepare and certify a transcript of record, pro edings and judgment in this cause, and transmit the sam to the Clerk of the Supreme Court of the United States;

And it is further ordered that the amount of the cost bond on said appeal herein be, and the same hereby is, fixed in the sum of $500.00.

Dated: June 28, 1941.

Phil S. Gibson, Chief Justice of the Supreme Court of the State of California.

[fols. 106-107] Citation in usual form showing service on Earl Warren, filed June 30, 1941, omitted in printing.

[fols. 108-112] Cost bond on appeal for $500.00 approved and filed June 28, 1941, omitted in printing.

[fol. 113] In Supreme Court of the United States, October Term, 1941

[Title omitted]

Stipulation as to Contents of Transcript of Record—Filed July 7, 1941

It Is Hereby Stipulated that the transcript of record to be filed in the Supreme Court of the United States pur-

suant to the appeal heretofore allowed herein shall include the following:

1. The printed Transcript on Appeal in the Supreme Court of the State of California, including the following documents:

(a) Appellant's complaint.
(b) Respondent's answer to complaint.
(c) Stipulation of Facts filed in the Superior Court of the State of California in and for the City and County of San Francisco.
(d) Findings of Fact and Conclusions of Law of the Superior Court of the State of California, in and for the City and County of San Francisco.
(e) Judgment of the Superior Court of the State of California, in and for the City and County of San Francisco.
(f) Judgment Roll.
[fol. 114] (g) Notice of Appeal.
(h) Stipulation to transcript on appeal.
(i) Clerk's Certificate to transcript on appeal.

2. Order of the Supreme Court of the State of California transferring the cause to the District Court of Appeal of the State of California, Third Appellate District, for hearing and decision.

3. Order substituting Charles J. McColgan, as Franchise Tax Commissioner of the State of California, as defendant in place of Charles G. Johnson, as Treasurer of the State of California.

4. Order of the Supreme Court of the State of California granting a hearing of the cause after hearing and decision by the District Court of Appeal of the State of California, Third Appellate District.

5. Judgment and opinion of the Supreme Court of the State of California, a copy whereof is shown as Exhibit "E" to the statement as to jurisdiction of the Supreme Court of the United States on appeal, document numbered 10 herein.

6. Appellant's petition for rehearing of the judgment of the Supreme Court of the State of California.

7. Order of the Supreme Court of the State of California denying a rehearing.

8. Remittitur of the Supreme Court of the State of California.

9. Petition for appeal, assignments of error and prayer for reversal.

10. Statement as to jurisdiction of the Supreme Court of the United States on appeal.

11. Order allowing appeal.

12. Notice under Rule 12, paragraph 2, Rules of the Supreme Court of the United States and proof of service thereof.

13. Citation and proof of service thereof.

14. Cost Bond.

15. Any opposing statement or motion filed by respondent pursuant to Rule 12(3).

[fol. 115] 16. Stipulation as to contents of praecipe.

Leland K. Neeves, James S. Moore, Jr., Attorneys for Appellant. Earl Warren, Attorney General of the State of California. H. H. Linney, Deputy Attorney General of the State of California. Valentine Brookes, Deputy Attorney General of the State of California; Attorneys for Respondent.

[fol. 115a] [File endorsement omitted.]

[fol. 116] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 117] IN SUPREME COURT OF THE UNITED STATES

STATEMENT OF POINTS TO BE RELIED UPON AND DESIGNATION OF THE PARTS OF THE RECORD TO BE PRINTED—Filed July 21, 1941

Comes now appellant in the above entitled cause and states that the points upon which it intends to rely are:

That the Supreme Court of the State of California e ed in rendering its said decision, affirming the judgment of the Superior Court of the State of California in and for the City and County of San Francisco, the court of first instance in said cause, in each of the respects hereinafter stated:

1. In holding that the California Bank and Corporation Franchise Tax Act, California Statutes of 1929, page 19, as amended, did not deprive Petitioner of its property with-

out due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

2. In holding that said Act did not impose a tax on income of Petitioner earned and derived from sources wholly outside of the State of California, thus depriving Petitioner [fol. 118] of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

3. In holding that said Act did not deprive Petitioner of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States, although said Act as construed by said Court levied a tax upon a percentage of Petitioner's net income allocated to the State of California by an arbitrary allocation formula (based upon a comparison of Petitioner's property, payroll and sales within California as compared to Petitioner's total payroll, property and sales), in spite of the fact that Petitioner's operations in the State of California were conducted at a loss of $82,851 and Petitioner in fact earned no net income from its operations within the State of California and derived no net income from sources within the State of California.

4. In holding that although in fact Petitioner's operations within the State of California resulted in a loss of $82,851, it was nevertheless subject to a tax on an assumed net income of more than $90,000 by application of the formula prescribed by said Bank and Corporation Franchise Tax Act as amended, and in holding that said Act in imposing such tax did not deprive appellant of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

5. In holding that Petitioner's business, although it consists only of buying and selling merchandise, is a "unitary" business; in holding that in the case of a unitary business the Bank and Corporation Franchise Tax Act imposes a tax based on a formula allocation of income regardless of an actual loss incurred on business done in California, and [fol. 119] in holding that said Act in so imposing such tax does not deprive appellant of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

6. In deciding this case by indulging in inferences and presumptions contrary to the provisions of paragraph 12 of the stipulation of facts upon which this case was tried.

Appellant represents that the whole of the record, as filed, is deemed necessary to be printed, except the following:

(1) Order of the Supreme Court of the State of California transferring the cause to the District Court of Appeal of the State of California, Third Appellate District, for hearing and decision.

(2) Order of the Supreme Court of the State of California granting a hearing of the cause after hearing and decision by the District Court of Appeal of the State of California, Third Appellate District.

(3) Appellant's petition for rehearing of the judgment of the Supreme Court of the State of California, except that there shall be printed

(a) the following matter appearing on page 1 of the appellant's printed petition for rehearing as filed in the Supreme Court of the State of California (page 39 of the Record certified to the Supreme Court of the United States by the Clerk of the Supreme Court of the State of California):

"To the Honorable Phil S. Gibson, Chief Justice, and to the Associate Justices of the Supreme Court of the State of California:

Appellant above named respectfully prays that a rehearing be granted in the above entitled cause." and

(b) the matter appearing under the subheading "The Decision Is Based On Inferences Or Presumptions Which It Was Stipulated Should Not Be Made" on pages 24 to 28 of appellant's printed petition for rehearing as filed in the Supreme Court of the State of California (pages 62 to 66 of the Record certified to the Supreme Court of the United States by the Clerk of the Supreme Court of the State of California).

[fol. 120] (4) Citation and proof of service.

(5) Cost bond on appeal.

Dated: July 18, 1941.

Leland K. Neeves, James S. Moore, Jr., Attorneys for Appellant.

[fol. 121] Receipt of copy of the foregoing statement and designation is hereby acknowledged, and Respondent hereby waives the right to designate any additional parts of the record to be printed, and consents to the hearing of this cause upon the parts of the record so designated by Appellant.

Earl Warren, Attorney General of the State of California, H. H. Linney, Valentine Brookes, Deputy Attorney General of the State of California, Attorneys for Respondent.

[fol. 122] [File endorsement omitted.]

Endorsed on Cover: File No. 45,611. California Supreme Court. Term. No. 283. Butler Brothers, Appellant, vs. Charles J. McColgan, as Franchise Tax Commissioner of the State of California. Filed July 19, 1941. Term No. 283 O. T., 1941.

(7219)

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CHARLES ELMORE CROPLEY

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 283

BUTLER BROTHERS, A CORPORATION,
Appellant,

vs.

CHARLES J. McCOLGAN, AS FRANCHISE TAX COMMISSIONER OF THE STATE OF CALIFORNIA.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA.

STATEMENT AS TO JURISDICTION.

LELAND K. NEEVES,
JAMES S. MOORE, JR.,
Attorneys for Appellant.

SCOTT, MACLEISH & FALK,
BROBECK, PHLEGER & HARRISON,
Of Counsel.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 283

BUTLER BROTHERS, A CORPORATION,

Appellant,

vs.

CHARLES J. McCOLGAN, AS FRANCHISE TAX COMMISSIONER OF THE STATE OF CALIFORNIA.

JURISDICTIONAL STATEMENT.

Butler Brothers, appellant in the above entitled cause, and applicant for the allowance of an appeal to the Supreme Court of the United States from the Supreme Court of the State of California, respectfully represents that the basis upon which appellant contends that the United States Supreme Court has jurisdiction upon appeal to review the final judgment herein is as follows:

I.

The Statutory Provision Believed to Sustain the Jurisdiction.

The statutory provision believed to sustain the jurisdiction is section 237 (a) of the Judicial Code as amended (28 U. S. C. A. section 344 (a)). There is drawn in ques-

tion in this suit the validity of a statute of the State of California on the ground of its being repugnant to the Constitution of the United States. The decision of the California Supreme Court, which is the highest court of the State of California in which a decision in this suit could be had, was in favor of its validity.

The case is one in which, under the legislation in force when the Act of January 31, 1928, was passed, a review could be had in the Supreme Court of the United States on writ of error. Under said last named Act an appeal has been substituted for a writ of error.

Act of January 31, 1928, Chapt. 14, 45 Stat. 54, as amended by Act of April 26, 1928, Chapt. 440, 45 Stat. 466.

II.

Statute of the State, the Validity of Which is Involved.

The statute of the State of California, the validity of which is involved, is the Bank and Corporation Franchise Tax Act of California (Statutes 1929, p. 19, as amended). Section 4, subdivision 3, of that Act as it stood at the times here material, provided:

> "With the exception of financial corporations, every corporation doing business within the limits of this State and not expressly exempted from taxation by the provisions of the constitution of this State or by this Act shall annually pay to the State for the privilege of exercising its corporate franchises within this State a tax according to or measured by its net income to be computed in the manner hereinafter provided at the rate of four per centum upon the basis of its net income for the next preceding fiscal or calendar year. In any event each such corporation shall pay annually to the State for the said privilege a minimum tax of twenty-five dollars."

Section 10 of said Act as it stood at the times here material provided:

> "If the entire business of the bank or corporation is done within this State, the tax shall be according to or measured by its entire net income; and if the entire business of such bank or corporation is not done within this State the tax shall be according to or measured by that portion thereof which is derived from business done within this State. The portion of net income derived from business done within this State shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, payroll, value and situs of tangible property, or by such other method of allocation as is fairly calculated to assign to the state the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation.
>
> "If the Commissioner reallocates net income upon his examination of any return, he shall, upon the written request of the taxpayer, disclose to him the basis upon which his reallocation has been made."

Other pertinent provisions of said Act are appended hereto as Exhibit "A".

III.

Date of Judgment and Date of Application for Appeal.

The judgment sought to be reviewed is a final judgment of the Supreme Court of the State of California, the highest court of that State in which a decision in the suit could be had. The date of said judgment was March 21, 1941. A petition for rehearing, subsequently filed within the alloted time and considered by the California Supreme Court, was denied by that court on April 17, 1941. The judgment herein thereupon became final for the purpose of appeal

and review by the Supreme Court of the United States on said last mentioned date.

Citizens Bank v. *Opperman*, 249 U. S. 448.

The date upon which application for appeal is presented is June 28, 1941.

IV.

Nature of the Case and the Rulings of the Supreme Court of the State of California.

The nature of the case and the rulings of the Supreme Court of the State of California deemed to bring the case within the jurisdictional provisions relied on are as follows:

This suit was brought by appellant in the Superior Court of the State of California in and for the City and County of San Francisco against the State Treasurer of the State of California to recover certain additional franchise taxes assessed against appellant amounting to $3,798.43 and interest thereon amounting to $344.67. Said franchise taxes were assessed under the provisions of the Bank and Corporation Franchise Tax Act above mentioned. Said franchise taxes so assessed and said interest were paid by appellant to the said State Treasurer under protest.

The said franchise taxes were assessed with respect to the year 1936, but in accordance with the statute were determinable in accordance with the net income of appellant for the year 1935.

Appellant filed its return for the year 1936, from which return it appeared that appellant had a loss of $82,851 for the year 1935. Accordingly appellant paid the minimum tax of twenty-five dollars, upon the filing of the return.

On January 25, 1937, the Franchise Tax Commissioner of the State of California gave notice to appellant of the

proposed additional assessment of $3,798.43. Thereafter and in due time appellant filed with said Commissioner a written protest under oath. A copy of said protest was attached to the Complaint herein as Exhibit "A" thereto, and a copy is appended thereto as Exhibit "B". The protest stated, among other things, that it was conceived that appellant's position was supported by *Hans Rees' Sons, Incorporated*, v. *North Carolina*, 283 U. S. 123.

On August 5, 1937, the said Franchise Tax Commissioner gave written notice to appellant that he had affirmed said proposed additional assessment. On September 8, 1937, the said Franchise Tax Commissioner assessed said additional taxes in said sum of $3,798.43, with interest thereon from March 15, 1936. Thereafter and on September 16, 1937, appellant paid to the State Treasurer the amount of said additional assessment of $3,798.43, with interest thereon amounting to $344.67. Said payment was made under protest, which protest was in writing and which protest stated the grounds upon which said appellant claimed that said additional tax and all thereof was void. A copy of said protest was attached to the Complaint herein as Exhibit "B" thereto, and is appended hereto as Exhibit "C". Among other things, it was stated in the protest that the tax was

> "a tax upon business and transactions conducted without the State of California, is without the power of jurisdiction of the State of California, will deprive Butler Brothers of property without due process of law, will deprive Butler Brothers of the equal protection of the law, and is in violation of its rights under the Constitution of the United States and the Constitution of the State of California.
>
> "The Bank and Corporation Franchise Tax Act, if construed as authorizing the assessment of the taxes here protested, is in violation of the Constitution of the United States and of the Constitution of the State of California."

The Complaint, filed October 18, 1937, specifically stated and claimed that said additional assessment and all thereof was void for each and all of the reasons and grounds set forth in said last named protest, to which reference was thereby made and which was incorporated in said Complaint as if therein set forth at length.

In his answer herein, the State Treasurer denied the allegations of the Complaint as to the invalidity of said assessment and further denied the allegations contained in said Exhibit "B" to said Complaint (Exhibit "C" hereto).

The case was tried upon a stipulation of facts. In that stipulation (paragraph 11 thereof) it was stated that appellant claimed

> "that its operations are not unitary in character; that its net income reasonably attributable to the business done within the State of California is the income derived from its San Francisco house alone which resulted in a loss in the year 1935; that the method of allocation used by the Commissioner is not in accordance with the provisions of the Bank and Corporation Franchise Tax Act, and that if said Act is construed as authorizing such method of allocation and assessment, said Act is in violation of the due process clause of the Fourteenth Amendment to the Constitution of the United States."

The trial court sustained the validity of the tax and entered judgment against appellant. In its judgment the trial court adopted the stipulation of facts as its own findings of fact and simply held that the additional assessment "was duly and regularly made" pursuant to the statute in question.

Appellant thereupon appealed to the Supreme Court of the State of California. Subsequently that court, pursuant to certain amendments to the Bank and Corporation

Franchise Tax Act made in 1939, ordered that Charles J. McColgan, as Franchise Tax Commissioner of the State of California, be substituted in place of Charles G. Johnson as Treasurer.

Thereafter the California Supreme Court transferred the case to the District Court of Appeal for the Third Appellate District for hearing. The Appellate Court held the assessment void and accordingly reversed the judgment of the trial court, with directions to the trial court to enter judgment for appellant. A copy of the judgment and opinion of the Appellate Court is appended hereto as Exhibit "D".

Thereupon, upon defendant's petition, the California Supreme Court directed that the case be re-transferred to it for hearing.

Upon hearing in that court, the assessment was held valid. The California Supreme Court held that appellant's business was "unitary" in character and that the use of an allocation formula was made mandatory by the statute. The statute as thus construed and applied was also held valid and in no way repugnant to the Federal Constitution. The judgment of the trial court was accordingly affirmed. A copy of the judgment and opinion of the California Supreme Court is appended hereto as Exhibit "E".

Appellant's petition for rehearing was, as stated, denied on April 17, 1941. Among other things, the petition for rehearing called the court's attention to the fact that in its decision of the case it had indulged in various inferences and presumptions directly contrary to the express stipulation of the parties, upon which stipulation the case had been tried. (Stipulation of facts, paragraph 12.)

The California Supreme Court did not regard the case of *Hans Rees' Sons, Incorporated,* v. *North Carolina,* 283 U. S. 123, as controlling. That the court clearly misconceived

the effect of the holding in this case is apparent from the statement in its opinion (Exhibit "E", p. 50) that:

> "Careful analysis of the underlying legal principles considered in the Hans Rees' case compels us to conclude that it, like the Underwood Typewriter and Bass Ale cases, supra, recognized that where a business is unitary in character, so that its separate parts cannot be fairly considered by themselves and the whole business in the several states derives a value from the unity of use, allocation of income upon a reasonable formula is properly sustained."

This statement can only be understood as meaning that where a business is "unitary" in character then, notwithstanding the evidence and the factual circumstances of the case, the use of an apportionment formula must necessarily be sustained. But this is precisely what this court in the *Rees* case did *not* hold.

The California Supreme Court also relied upon the decision of this Court in *North American Cement Corporation* v. *Graves*, 299 U. S. 517. In its opinion herein (Exhibit "E", p. 52) the court said that that case holds that the business there involved was a "unitary" business and that

> "separate accounting in accordance with recognized accounting practice is insufficient evidence to disprove the propriety and presumption of fairness of formula allocation."

The California Supreme Court, just as in the case of the *Rees* case, misconceives the holding in the *North American Cement Corporation* case. It apparently was of the view that *the North American Cement Corporation* case was inconsistent with and in effect overruled the *Rees* case. But what this court held in the *North American Cement Corpo-*

ration case is precisely what is stated in the court's *per curiam* opinion that the New York statute

> "is valid upon its face and it has not been shown to have been so applied as to violate appellant's constitutional rights."

This Court did not hold that "separate accounting practice" is insufficient evidence to disprove the propriety and presumption of fairness of formula allocation. Neither did this court hold that a formula allocation would be sustained where the established facts show the unreasonable and arbitrary effect of the application of the formula.

V.

Cases Sustaining the Jurisdiction of the United States Supreme Court to Review the Judgment of the California Supreme Court on Appeal.

In the cases decided by this Court where the question is as to the validity of a statutory method of apportionment of net income—with the consequent question as to the validity of the statute directing or authorizing such method of apportionment—the review has been by way of an appeal from the judgment of the State court.

Underwood Typewriter Co. v. *Chamberlain*, 254 U. S. 113;

Bass, Ratcliff & Gretton v. *State Tax Commissioner*, 266 U. S. 271;

Hans Rees' Sons, Incorporated, v. *North Carolina*, 283 U. S. 123;

N. & W. Ry. Co. v. *North Carolina*, 297 U. S. 682;

North American Cement Corporation v. *Graves*, 299 U. S. 517.

VI.

The Questions Involved Are Substantial.

The facts which were stipulated by the parties to this case show that appellant's business in California for the year 1935 resulted in a loss of $82,851.00, upon which no tax accrued for the year 1936 other than the minimum tax of twenty-five dollars.

Notwithstanding the stipulated facts, the Franchise Tax Commissioner under the asserted authority of the Bank and Corporation Franchise Tax Act (Section 10 thereof) applied an allocation formula which resulted in a claimed income of $93,551.50. By the application of the statutory allocation formula a loss of $82,851 was converted into a taxable income of $93,551.50.

Appellant makes no contention that a statutory method of allocation in determining net income is *per se* invalid or that a statute providing for such allocation method of determining income is void upon its face. Appellant does contend under the principles announced in the *Rees* case that the agreed facts in this case show that the application of the statutory method of apportionment has resulted unreasonably and arbitrarily and has operated to create a taxable net income where none existed in point of fact. As the California Appellate Court said in its opinion (Exhibit "D", p. 41):

> "We therefore conclude that the stipulated facts show that the company actually incurred a loss in California; that its California earnings could have been accurately ascertained without the necessity of recourse to any arbitrary formula, and that the use of such formula results in the imposition of a tax on income not earned in California, and therefore not subject to its taxation power."

Appellant challenges the validity and constitutionality of the California Act here involved. As it has been construed and applied by the California Supreme Court to the stipulated facts, it serves to create income where none exists in fact, and, therefore, taxes income which is not within the jurisdiction of the State of California. In so doing appellant has been deprived of its property without due process of law and has been denied the equal protection of the laws in contravention of the Fourteenth Amendment. Just as in the *Rees* case, evidence which was found to be lacking in the *Underwood* and *Bass* cases is present in the instant case—evidence which shows that the method of apportionment provided for by the California statute

> "albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions"

within the State of California (*Hans Rees' Sons, Incorporated,* v. *North Carolina,* 283 U. S. 123).

The Facts.

The facts upon which this case was tried were stipulated by the parties and said stipulation of facts was adopted by the trial court as its own findings of fact. The stipulation appears in the printed transcript on appeal in the State Supreme Court. The facts so stipulated were as follows:

Butler Brothers, plaintiff herein (hereinafter called the Company), is a corporation organized under the laws of Illinois and is qualified to conduct business in California. Its corporate principal place of business is in Chicago, Illinois. The Company is engaged in the wholesale dry goods and general merchandise business, purchasing from manufacturers and others, and selling such commodities to retailers only. It maintains and operates wholesale distributing houses at Chicago, Illinois, Minneapolis, Minnesota, St.

Louis, Missouri, Jersey City, New Jersey, Baltimore, Maryland, Dallas, Texas, and San Francisco, California. The San Francisco house was opened by the Company in 1928, being the last established of all the Company's houses, except that the one at Baltimore was acquired as a going concern in 1930.

Stocks of goods are maintained at each of the Company's houses hereinabove mentioned, from which sales in the respective territories served by each house are made. Each house serves a separate trade territory, having its own sales force, and all sales made by the Company in the State of California are made from the San Francisco house. Each house handles its own sales and all solicitation, credit and collection arrangements in connection therewith. Books of account are kept at each house, wherein are entered the sales made thereat, the amounts paid for goods sold therefrom, transportation charges and other operating expenses, including the allocation of certain common expenses referred to in paragraph 4. It is agreed that all receipts from sales made in California have been credited to the San Francisco house.

The Company maintains a central buying division through which goods for resale are ordered, but such goods are shipped by the manufacturers to the houses for which ordered, where the cost thereof and transportation charges thereon are entered on the books of the house. No charges are made against any house for the benefit of the Company or any other house by reason of such centralized purchasing, but the actual cost of operating the centralized buying division is allocated to the houses, as stated in paragraph 4. The greater part of other operating expenses incurred by the Company are directly and exclusively incurred at the respective houses, including such items as labor, rentals and similar expenses.

Paragraph 4 of the stipulation provided as follows:

> "There are certain items of expense which are incurred and paid by the Company for the benefit of all houses, the costs of which are allocated to the respective houses. No question exists as to the accuracy of the amounts of such expense or to the method of allocation employed, which is in accordance with recognized accounting practices. For the year 1935 the amount of such allocated expense charged to the San Francisco house was $100,091. For the purposes of this case, and without prejudice to the claims of either party in any subsequent year, it is agreed that approximately 75% of the $100,091 overhead expense so allocated would have been incurred even though the San Francisco house was not operated, and that the accuracy and propriety of the basis of allocation of such common expenses for the year 1935 are admitted. Included in such expenses are executive salaries, certain accounting expenses, the cost of operating a central buying division, and a central advertising division. Except for such common expenses, each house is operated independently of each other house."

The Company computed its income from the operation of the San Francisco house by deducting from the gross receipts from sales of merchandise in California, determined as indicated in paragraph 2 of the stipulation, the costs of such merchandise, determined as indicated in paragraph 3, the direct expenses of the San Francisco house referred to in paragraph 3, and the indirect expense allocated to the San Francisco house in the manner described in paragraph 4. According to this computation, the San Francisco house operated at a loss of $82,851 during the year 1935.

In the year 1935 the operations of all houses of the Company produced a profit of $1,149,677. The additional tax assessed by the Franchise Tax Commissioner was predicated on the allocation to California of 8.1372% of the total income of the Company derived from all sources, such

percentage having been determined by mathematical average of the percentages which (a) value of real and tangible personal property, (b) wages, salaries, commissions and other compensation of employees, and (c) gross sales, less returns and allowances, attributable to the San Francisco house bore to the corresponding items of all houses of the Company. It is also agreed that the Franchise Tax Commissioner, in imposing the additional assessment upon the Company, did not give consideration to any other factor or method of allocation. No question exists as to the accuracy of the Commission's calculation, nor respecting the use of the above formulas, if, by reason of the facts stipulated herein, a formula for allocation to California of a portion of the Company's income from all sources is proper. This stipulation is made without prejudice as to any other year than that on which the tax here involved is predicated.

In the year 1935 the total sales made by the Company at all houses amounted to $66,326,000, of which $5,206,000 were made from the San Francisco house. The purchases made for the account of the San Francisco house were substantially in the same proportion to total purchases. All purchases made by the Company for sale at its various houses are made through a central buying division. By reason of the volume of purchases made by the Company more favorable prices are obtained than would be obtainable in respect of purchases for the account of any individual house operated by the Company.

The addition of purchases in an amount equal to the purchases made for the account of the San Francisco house results in no more favorable prices than could be obtainable in respect of purchases in an amount equal to the purchases which would be made by the Company for its other houses if the San Francisco house were not in existence, and a reduction in the volume of purchases in an amount equal to the purchases made for the San Francisco house would.

result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the Company. The stipulation in this paragraph shall not be deemed an admission by defendant that plaintiff is entitled to segregate the income of its San Francisco house from that of other houses for purposes of computing franchise tax.

It was further stipulated that it was claimed by the State Treasurer that by reason of the facts set forth in the stipulation

> "the operations of the Company are unitary in character and that the formula for allocation of income used by the Franchise Commissioner was lawful and proper and that the Company is not entitled, for the purpose of determining tax payable under the Bank and Corporation Franchise Tax Act, to use separate accounting of its San Francisco house to determine its net income in the State of California."

and further that

> "It is claimed by the Company that its operations are not unitary in character; that its net income reasonably attributable to the business done within the State of California is the income derived from its San Francisco house alone which resulted in a loss in the year 1935; that the method of allocation used by the Commissioner is not in accordance with the provisions of the Bank and Corporation Franchise Tax Act, and that if said Act is construed as authorizing such method of allocation and assessment, said Act is in violation of the due process clause of the Fourteenth Amendment to the Constitution of the United States."

It was further stipulated that the stipulations of fact were without prejudice to appellant's claim

> "that its earnings in California are solely those derived from operation of its San Francisco house, and

> that it is taxable in California only in respect of such earnings, without regard to earnings from its operations in other states * * *"

and were without prejudice to the claim of the State Treasurer that appellant's

> "operations in California are of such a character as to be incapable of segregation from its other operations, and that plaintiff may be taxed on an allocation of its entire net income in the manner done by the defendant."

The Law.

The Tax Here Involved is Void. The California Statute as Construed and Applied by the California Supreme Court is Likewise Void. The Case of Hans Rees' Sons, Incorporated, v. *North Carolina, 283 U. S. 123, is Controlling.*

The tax here involved results from applying to appellant's business the statutory apportionment formula—notwithstanding that the agreed facts show that appellant's operations in California for 1935, upon which the 1936 tax is based, were conducted at an actual loss.

The application of the statutory apportionment formula has the effect of converting a *loss* of $82,851 into a taxable income of $93,551.50.

In *Hans Rees' Sons, Incorporated,* v. *North Carolina,* 283 U. S. 123, it appeared that the corporation there involved operated a manufacturing establishment in North Carolina. It bought hides, manufactured them into merchandise at its said factory and sold the manufactured merchandise in numerous other states. The North Carolina statute provided for the use of an apportionment method in determining the net income of the company in North Carolina. The taxing authorities applied the method, and the question was whether or not the tax was valid

and whether the statute as so applied was itself valid. The State court sustained the tax and held the statute valid. Reliance was had upon *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113, and *Bass, Ratcliff & Gretton* v. *State Tax Commissioner*, 266 U. S. 271. Evidence was sought to be introduced by the corporation tending to show that its income in North Carolina was in fact materially less than the amount of income resulting from the application of the statutory method of apportionment. The North Carolina Supreme Court disregarded this evidence and held that the apportionment method must in any event be applied. This court reversed the judgment, saying:

> "Evidence which was found to be lacking in the *Underwood* and *Bass* cases is present here. These decisions are not authority for the conclusion that where a corporation manufactures in one State and sells in another, the net profits of the entire transaction, as a unitary enterprise, may be attributed, regardless of evidence, to either State. * * *
>
> "Undoubtedly, the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business, and all the factors in that enterprise are essential to the realization of profits. The difficulty of making an exact apportionment is apparent and hence, when the State has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases. But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one State regardless of the extent to which it may be derived from the conduct of the enterprise in another State. * * * And the principle that was recognized in *National Leather Co.* v. *Massachusetts, supra,*

was that a tax could lawfully be imposed upon a foreign corporation with respect to 'the proportionate part of its total net income which is attributable to the business carried on within the State.' When, as in this case, there are different taxing jurisdictions, each competent to lay a tax with respect to what lies within, and is done within, its own borders, and the question is necessarily one of apportionment, evidence may always be received which tends to show that a State has applied a method, which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction."

In the *Underwood* case this Court had said:

"There is consequently nothing in this record to show that the method of apportionment adopted by the state was inherently arbitrary, or that its application to this corporation produced an unreasonable result."

In the *Bass* case this Court had said that the situation was to all intents the same as in the *Underwood* case and that it was not shown any more than in the *Underwood* case

"that this application of the statutory method of apportionment has produced an unreasonable result."

In both the *Underwood* and *Bass* cases, therefore, this Court sustained the statute and the resulting tax.

In *North American Cement Corporation* v. *Graves*, 299 U. S. 517, which seems to be the chief reliance of the defendant herein, an apportionment method and resulting tax was sustained by this Court. In that case the judgments of the New York courts were upheld by this Court upon the specific ground that the statute

"is valid upon its face and it has not been shown to have been so applied as to violate appellant's constitutional rights." (Citing the *Bass* case.)

Defendant seems to think that the *North American Cement* case has overruled the *Rees* case. There is, however, no conflict whatsoever between these cases or between the *Rees* case and cases like the *Underwood* and *Bass* cases. Appellant here does not contend that the California statute is invalid on its face or that the apportionment method, which at least is permissible under the California statute under certain factual conditions, is *per se* invalid. Appellant has made the same contention throughout this case from its very inception, that under the factual situation here presented the apportionment method as applied by the California taxing authorities has resulted unreasonably, just as the apportionment method did in the *Rees* case, and we also point out the California Supreme Court has fallen into the same error as did the North Carolina court in the *Rees* case, namely, by holding that notwithstanding the factual situation an apportionment method is mandatory.

As heretofore stated, the application of the apportionment method in the instant case has resulted in converting what was an operating loss in fact to a taxable profit. Appellant contends that the factual showing in the instant case is even stronger than the factual showing in the *Rees* case, for in that case it appeared that there was some taxable gain at least in North Carolina. In the instant case there was a loss in fact of $82,851.

A State, we contend, cannot, consistently with the principles announced in the *Rees* case, merely by legislative or administrative *fiat*, convert a loss into a taxable gain.

That this Court does not regard the *Rees* case as overruled or in any way impaired is demonstrated by the fact of its recent citations in *James* v. *Dravo Contracting Co.*, 302 U. S. 134, and *Department of the Treasury of the State of Indiana, et al.*, v. *Wood Preserving Corporation*, — U. S. —, decided April 28, 1941.

When the Franchise Tax Commissioner first proposed to levy a tax based upon the opportionment method, appellant urged its invalidity under the principles of the *Rees* case. See Exhibit "A" to the Complaint (Exhibit "B" hereto). These objections were carried forward into the second protest made at the time the additional assessment was paid. See Exhibit "B" to the Complaint (Exhibit "C" hereto).

In its opinion herein the District Court of Appeals said (Exhibit "D", p. 41):

> "We therefore conclude that the stipulated facts show that the company actually incurred a loss in California; that its California earnings could have been accurately ascertained without the necessity of recourse to an arbitrary formula, and that the use of such formula results in the imposition of a tax on income not earned in California and therefore not subject to its taxing power."

In marked contrast to the above holding, the California Supreme Court, as is shown by its opinion herein, contents itself by holding, first, that appellant's business is a "unitary" one and that, therefore, the apportionment method of determining the tax is of necessity valid and proper. That court states (Exhibit "E", p. 45):

> "If there is any evidence to sustain a finding that the operations of appellant in California during the year 1935 contributed to the net income derived from its entire operations in the United States, then the entire business of appellant is so clearly unitary as to require a fair system of apportionment by the formula method in order to prevent overtaxation to the corporation or undertaxation by the state."

The principles upon which the California Supreme Court has gone in sustaining the validity of this tax cannot be reconciled with the principles announced by this court in the *Rees* case.

The Georgia Court has summed up the proposition very concisely in a recent decision there. After construing the Georgia statute to tax even domestic corporations only upon that portion of their business reasonably attributable to the trade or business within the State—as does the California statute—the court went on to determine the propriety of an allocation formula. The court said:

> "Where the business done within the State is distinctly divisible from the business done in other jurisdictions by the same corporation, ordinarily the total income from all operations can not be used as a basis of computation. See 75 L. Ed. 900, annotation. * * * The theories of allocation can have no place in the inquiry if the net income within the State stands on its own footing unmixed with outside business."
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> (*Mexican Petroleum Corporation of Georgia* v. *Head*, Ga. App., 13 S. E. 2d, p. 887, 890.)

Among other cases referred to by the court was the *Rees* case.

VII.

The California Statute and the Tax Here Involved Are Void, Whether or not Appellant's Business is a "Unitary" One. As a Matter of Fact, However, Appellant's Business is Not Unitary in Character.

As stated, the California Supreme Court premises its conclusion upon the holding that appellant's business is "unitary". The type of business which this court viewed as "unitary" in the *Underwood, Bass* and *Rees* cases were manufacturing businesses. A manufacturing business does not lend itself to a degree of separableness to which a wholesaling merchandise business lends itself. The separableness of the various branches of a wholesaling merchandise business, like that of appellant's, is demonstrated from the

agreed facts herein. The determination of the net income of any one of the branch houses of appellant is not subject to the inherent difficulties which exist in the case of a manufacturing business. As shown in the stipulation of facts, each branch house, including that at San Francisco, is operated practically as an independent concern, excepting only that each branch house is charged with a proportionate share of certain common expense. And, inasmuch as each house is charged only with the actual cost of merchandise bought for wholesale, plus the transportation expense from the mill or factory to the given house, each house obviously is given the fullest possible advantage of the aggregate purchasing power of the company. Appellant's business is, in truth, merely an aggregation of seven independently operated businesses, albeit the seven houses are under a common legal ownership and control.

No question is raised in this case as to the reasonableness of the allocation of the so-called common expense of the seven houses. And no question is raised as to the accuracy of appellant's accounting practices at its San Francisco branch. The profit or income from appellant's California operations can only be the result of the sale of merchandise at the San Francisco house to customers residing in the State of California and elsewhere in the territory attributable to that house, all of which income or profit was included when appellant filed its return. Consistently with the *Rees* case, appellant might have attributed the whole of its so-called buying profit to Illinois, where its principal office is located and its central buying division operates. Appellant did not do so, however, but gave to its California branch its full share of such buying profit when it charged its California house with only the actual cost of the merchandise.

In its opinion (Exhibit "E", p. 46) the California Supreme Court said:

> "It is our opinion that the sales made in each of the seven states in which appellant does business must be proportionately credited with the profits resulting from the purchasing power which such sales in the aggregate produce."

But that is precisely what has been done in the instant case. Nevertheless, the California house still operated at a loss for the year of $82,851. Obviously had the California house not been so credited with its proportionate share of the "profits resulting from the purchasing power which such sales in the aggregate produce", the operating loss of the California house would have been correspondingly greater.

Where, as here, appellant's various houses are operated substantially as independent business units, and where, as here, the California house has received its proportionate share of the so-called buying profit, and where, as here, the indisputable figures to which the State has stipulated clearly and unmistakably disclose the amount of the operating gain or loss, an apportionment method, whether required or permitted by statute, cannot be sustained consistently with the *Rees* case.

The difficulties in determining the income in any given taxing State, in the case of a unitary business like that of manufacturing, are, of course, to be recognized. Such difficulties have no substantial existence in the case of a business like appellant's, operated as appellant's business is operated.

Under such circumstances there is every conceivable reason for applying the doctrine of the *Rees* case and determining net income or loss by the actual figures themselves—which figures, as in this case, reflect the actual facts of the situation—and no reason whatsoever for applying an apportionment formula.

It is universally recognized, we believe, that an apportionment formula is resorted to only to solve the difficulties inherent in accurately determining income in the various States of a so-called unitary business. Where, as here, and as the California Appellate Court so clearly pointed out, the income or loss is readily and accurately determinable by the figures themselves, no excuse exists for the application of a mere formula. To apply such a formula is apt to result, and has resulted in the instant case, in assigning to California income which was non-existent in fact in that State.

Respectfully submitted,

LELAND K. NEEVES,
JAMES S. MOORE, JR.,
Attorneys for Butler Brothers,
Appellant Herein.

EXHIBIT "A".

AN ACT TO CARRY INTO EFFECT THE PROVISIONS OF SECTIONS 14 AND 16 OF ARTICLE XIII OF THE CONSTITUTION OF THE STATE OF CALIFORNIA RELATING TO BANK AND CORPORATION TAXES, APPROVED MARCH 1, 1929, STATS. 1929, P. 19.

"4. *Financial corporation to pay tax.* • • •

• • • • • • •

(3) *Corporations other than financial doing business in this State to pay tax. Minimum tax.* With the exception of financial corporations, every corporation doing business within the limits of this State and not expressly exempted from taxation by the provisions of the Constitution of this State or by this act, shall annually pay to the State, for the privilege of exercising its corporate franchises within this State, a tax according to or measured by its net income, to be computed, in the manner hereinafter provided, at the rate of four per centum upon the basis of its net income for the next preceding fiscal or calendar year. In any event, each such corporation shall pay annually to the State, for the said privilege, a minimum tax of twenty-five dollars.

• • • • • • •

6. *The term 'gross income'*, as herein used, includes gains, profits and income derived from the business, of whatever kind and in whatever form paid; gains, profits or income from dealings in real or personal property; • • •

8. *Deductions allowed.* In computing 'net income' the following deductions shall be allowed:

(a) *Expenses.* • • •

(b) *Interest.* • • •

(c) *Taxes or licenses.* • • •

(d) *Uncompensated losses.* • • •

(e) *Bad debts.* • • •

(f) *Depreciation.* • • •

(g) *Depletion.* • • •

• • • • • • •

10. *Computation of tax on intrastate business.* If the entire business of the bank or corporation is done within this State, the tax shall be according to or measured by its entire net income; and if the entire business of such bank or corporation is not done within this State, the tax shall be according to or measured by that portion thereof which is derived from business done within this State. The portion of net income derived from business done within this State, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, pay roll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation.

If the commissioner reallocates net income upon his examination of any return, he shall, upon the written request of the taxpayer, disclose to him the basis upon which his reallocation has been made.

12. *Computation of net income.* The net income shall be computed upon the basis of the taxpayer's annual accounting period, fiscal year or calendar year as the case may be, in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of said commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year, or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

* * * * * * *

13. *Returns.* (a) Every bank and corporation shall, within two months and fifteen days after the close of its income year, transmit to the commissioner a return in a form prescribed by him, specifying, for the income year,

all such facts as he may by rule, or otherwise, require in order to carry out the provisions of this act.

* * * * * * *

15. *Form of returns.* Every return required by this act to be filed with said commissioner shall be verified by an executive officer of the bank or corporation. Blank forms of return shall be furnished by said commissioner on application, but failure to secure such a form shall not release any taxpayer from the obligation of making a return hereunder.

* * * * * * *

18. *Penalties for failing to file, or filing false returns.* Any bank or corporation failing or refusing to furnish any return hereby required to be made or failing or refusing to furnish a supplemental return or other data required by the commissioner, or rendering a false or fraudulent return, shall be guilty of a misdemeanor and subject to a fine of not exceeding five thousand dollars ($5,000) for each such offense.

* * * * * * *

24. *Interest on unpaid taxes.* (a) Interest upon the amount determined as a deficiency under the provisions of section 25 of this act shall be assessed at the same time as the deficiency, shall be paid upon notice and demand from the commissioner, and shall be collected as a part of the tax, at the rate of six per centum per annum from the date prescribed for the payment of the tax (or, if the tax is paid in installments, from the date prescribed for the payment of the first installment) to the date the deficiency is assessed.

* * * * * * *

25. *Examination of returns. Notice of additional tax.* As soon as practicable after the return is filed, the Commissioner shall examine it and shall determine the correct amount of the tax. If the commissioner determines that

the tax disclosed by the original return is less than the tax disclosed by his examination he shall mail notice to the taxpayer at its post-office address (which must appear on its return) of the additional tax proposed to be assessed against it. Such notice shall set forth the details of the proposed additional assessment and of computing said tax.

Protest. Within sixty days after the mailing of said notice the taxpayer may file with the commissioner a written protest against the levy of the proposed additional tax, as computed by the commissioner, specifying therein the grounds upon which the protest is based. The protest must be under oath.

. . . . . ."

EXHIBIT "B".

(Exhibit "A" to the Complaint.)

Charles J. McColgon
Franchise Tax Commissioner
Sacramento, California

Re No. 8350.

DEAR SIR:

Protest is herewith made to your proposed additional franchise tax assessment amounting to $3,798.43.

The proposed additional assessment is based upon the theory that the general net income of the undersigned from the whole of its business transacted in the United States should be allocated to the State of California upon the basis as set forth in Schedule J of the return.

There was attached to the return a statement calling attention to the fact that the actual operations of the San Francisco branch house had resulted in an actual loss of $82,851 for the calendar year 1935, which statement was supported by a schedule attached showing the result of such operations. It is not understood that the figures there given are in any way disputed.

The question, therefore, is as to whether the statutory method of allocation should be given effect as against the actuality of the case.

Any method of allocation of the kind set forth in Schedule J is to a large extent arbitrary and is intended, and can be sustained, only as a means for arriving at net income attributable to the business carried on in the State of California. If such a method of allocation, or if any statutory or arbitrary method of allocation, works out in actual practice with a reasonable approximation of income attributable to California the method will be sustained. If, however, such method does not so work out, and results, in practical effect, in attributing to the State of California an unreasonable amount of income as compared to the business of the company done in its entirety and in other jurisdictions, or creates in California an income non-existent in fact, the statutory method of allocation must give way, and will not be sustained.

The undersigned respectfully insists that inasmuch as the actual results of the operation of its business in the State of California is a loss the statutory method of allocation is inapplicable, and that therefore it is subject only to a minimum tax.

It is conceived that the position here taken is supported by *Hans Rees' Sons, Incorporated v. North Carolina*, 283 U. S. 123.

Undersigned again states and insists, as it stated and insisted in its return as filed, that to impose a tax based upon the method of allocation set forth in Schedule J of the return is a violation of the undersigned's rights under both the California and United States Constitutions. An oral hearing is requested.

Respectfully submitted,

BUTLER BROTHERS,
By FRANK J. KEARNS,
Treasurer.

STATE OF ILLINOIS,
County of Cook, ss:

Frank J. Kearns being first duly sworn upon oath deposes and says that he is Treasurer of Butler Brothers, the

corporation whose name is subscribed to the foregoing protest; that he is familiar with the matters contained in said protest and that the same are true both in substance and in fact; and that as Treasurer he subscribed the name of said corporation to said protest and his own name as treasurer of said corporation.

FRANK J. KEARNS.

Subscribed and sworn to before me this 20th day of March, A. D. 1937.

A. F. BODENSTAB,
Notary Public.

[SEAL.]

EXHIBIT "C".

(Exhibit "B" to the Complaint.)

Hon. Chas. J. McColgan,
Franchise Tax Commissioner,
Sacramento, California,

and

Hon. Charles G. Johnson,
State Treasurer,
Sacramento, California.

GENTLEMEN:

There is paid herewith the sum of $4,143.10, being the additional tax imposed for the taxable year ended December 31, 1936 on the undersigned under the Bank and Corporation Franchise Tax Act, as set forth in "Notice of additional franchise tax proposed to be assessed", dated January 25, 1937, and in "Notice of action of Franchise Tax Commissioner upon taxpayer's protest", dated August 5, 1937, in the amount of $3798.43, and interest thereon from March 15, 1936 in the amount of $344.67. Said sum and all thereof is paid under protest, the grounds of said protest being:

Butler Brothers is a corporation organized and existing under the laws of Illinois, doing business in the State of

California. Its principal place of business is in the City of Chicago, County of Cook, and State of Illinois. It maintains and operates seven distributing or branch houses in the following localities: Chicago, Illinois; Minneapolis, Minnesota; St. Louis, Missouri; Jersey City, New Jersey (which includes sales offices and sample rooms in New York City); Baltimore, Maryland; Dallas, Texas, and San Francisco, California. The business of the company is the wholesaling of general merchandise. It maintains at its San Francisco house a stock of merchandise from which orders received and accepted at San Francisco are filled. It also maintains in the City of Los Angeles a sales and sample room. Stocks of merchandise are also maintained at the above-mentioned distributing houses, out of which orders are filled in the territory tributary to said respective houses. All of the sales made by Butler Brothers in California and territory tributary to the San Francisco house are made through the San Francisco house (including the Los Angeles sales and sample room), and the San Francisco house, together with said Los Angeles sales and sample room, is the only part of its business conducted within the State of California.

Separate accounts are kept of the operation of each branch of the establishment of Butler Brothers, including the San Francisco branch. All merchandise sold therein is charged at actual cost and other expenses of conducting said business are directly apportioned to said San Francisco branch, so that the exact income and expenses thereof can be ascertained. During the calendar year 1935, said San Francisco branch operated at a loss of $82,851.00 and the minimum tax under the Bank and Corporation Franchise Tax Act, to wit: $25.00, was paid by said Butler Brothers on or about March 15, 1937.

The additional assessment, payment of which is herewith protested, is predicated upon the allocation to California of income of Butler Brothers derived solely from operation of its business in states other than in California, and no part of the net income of Butler Brothers is derived from business done within the State of California.

The allocation to California of income derived from business done without the State of California does not fairly or at all assign to the State of California the net income of Butler Brothers reasonably attributable to the business done within this state and subjects Butler Brothers to double taxation.

The method of allocation followed by the Franchise Tax Commissioner is arbitrary and unreasonable and does not fairly or at all allocate to California the net income derived from business done within the State of California. To the contrary, the same purports to allocate to California income derived wholly from business done without the State of California. In fact, no net income has been derived from business done within the State of California.

The tax assessed upon Butler Brothers by the Franchise Tax Commissioner is a tax upon business and transactions conducted without the State of California, is without the power of jurisdiction of the State of California, will deprive Butler Brothers of property without due process of law, will deprive Butler Brothers of the equal protection of the law, and is in violation of its rights under the Constitution of the United States and the Constitution of the State of California.

The Bank and Corporation Franchise Tax Act, if construed as authorizing the assessment of the taxes here protested, is in violation of the Constitution of the United States and of the Constitution of the State of California.

Respectfully submitted,

BUTLER BROTHERS,
(Signed) D. R. TREAT,
Comptroller.

STATE OF ILLINOIS,
County of Cook, ss:

D. R. Treat, being first duly sworn upon oath deposes and says:

That he is Comptroller of Butler Brothers, the corporation whose name is subscribed to the foregoing protest; that he is familiar with the matters contained in said protest and that the same are true both in substance and in fact; and that as Comptroller he subscribed the name of

said corporation to said protest and his own name as Comptroller of said corporation.

(Signed) D. R. TREAT.

Subscribed and sworn to before me this 10th day of September, 1937.

[SEAL.] (Signed) A. F. BODENSTAB,
Notary Public in and for the County of Cook, State of Illinois.

(Endorsed:) Filed October 18, 1937. H. A. van der Zee, Clerk, by F. H. Kockler, Deputy Clerk.

EXHIBIT "D".

San Francisco—J. J. Trabucco, Judge.

Civil No. 6464. Third Appellate District.

May 18, 1940.

101 C. A. D. 612.

BUTLER BROTHERS (a Corporation), *Plaintiff and Appellant,*

v.

CHARLES J. McCOLGAN, as Franchise Tax Commissioner of the State of California, in the Place and Stead of Charles G. Johnson, State Treasurer of the State of California, *Defendant and Respondent.*

This action was brought to recover the sum of $4,143.10, being the amount of taxes and interest thereon paid to respondent under protest. Judgment was entered in favor of respondent, and plaintiff appealed therefrom.

The cause was submitted upon an agreed statement of facts which may be summarized as follows:

Plaintiff and appellant, Butler Brothers (herein called "the Company"), is an Illinois corporation, having its principal corporate office at Chicago. It is engaged in the wholesale dry goods and general merchandise business, purchas-

ing from manufacturers and others, and selling to retailers only. It operates seven distinct wholesale houses at Chicago, Jersey City, Baltimore, Minneapolis, St. Louis, Dallas and San Francisco. Each of these houses serves a separate trade territory. At each house stocks of goods are maintained, from which sales are made in its territory. Each handles its own sales, and all solicitation, credit and collection arrangements in connection therewith, and keeps books of account showing the operations of the house. All sales in California were made from the San Francisco house and all receipts credited thereto.

The greater part of the operating expense of the houses is directly and exclusively incurred at the respective houses, including such items as labor, rentals, etc. There are, however, some common expenses such as executive salaries and corporate overhead and the expense of operating a central buying division and a central advertising division. These expenses are apportioned to the respective houses on bases which, it is agreed, are in accord with recognized accounting practice, and the accuracy and propriety of such bases of apportionment are here conceded. The aggregate of such common expenses so charged to the San Francisco house for the year 1935 was $100,091, of which, it is agreed, approximately 75 per cent would have been incurred whether or not the San Francisco house were operated. Except for such common expenses, each house is operated independently of each other house.

Through a central buying agency goods required for resale in the various houses are ordered, but such goods are shipped directly from the manufacturer to the houses, where the cost thereof, with transportation charges thereon, is entered on the books of the house. No charges are made against any house for the benefit of the company, or any other house by reason of such centralized purchases, but the actual cost of operating the central buying division is allocated to the houses as stated in the preceding paragraph. By reason of the volume of purchases so made, more favorable prices are obtained than would be obtainable in respect to purchases for the account of any individual house, but addition or subtraction of purchases in

the volume made for the San Francisco house would have no effect on the prices obtainable for the remaining houses.

The accounts of the San Francisco house, computed by deducting from the gross receipts from all sales made therefrom (which includes all sales made and business done in California) the actual cost of merchandise and other direct expenses, and the apportioned share of common expenses previously described, showed for the year 1935 a loss of $82,851. Within the time allowed by law a report showing this loss was made and the minimum tax of $25 was paid for the year 1936. During the year 1935 the operations of all houses of the company produced a profit of $1,149,677. The commissioner subsequently assessed an additional tax of $3,798.43, which, with interest amounting to $344.67, was paid under protest on September 16, 1938. The additional assessment was predicated on the allocation to California of 8.1372 per cent of the company's total income derived from all sources. This percentage was a mathematical average of the percentages which the value of the tangible property, payroll and gross sales attributable to California bore to the corresponding items of all houses of the company. If an allocation is proper, use of the particular percentage here used is not questioned.

The tax in question was levied under the provisions of section 10 of the Bank and Corporation Franchise Tax Act (General Laws, Act 8488, vol. 2, p. 3851). That section provides:

"If the entire business of the bank or corporation is done within this state, the tax shall be according to, or measured by its entire net income; and if the entire business of such bank or corporation is not done within this state, the tax shall be according to, or measured by that portion thereof which is derived from business done within this state. The portion of net income derived from business done within this state, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, payroll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the state the portion of net income reasonably attributable to the business done

within this state and to avoid subjecting the taxpayer to double taxation * * *."

It is contended by appellant that the method by which the tax was fixed and computed was unauthorized and unlawful, and that such method had the effect of taxing plaintiff on, and in respect to income derived from sources beyond the jurisdiction of the state. This resulted, it is contended, in a denial of due process of law, and of the equal protection of the law, in violation of the Fourteenth Amendment of the Constitution of the United States.

On the other hand, respondent contends that the tax was levied upon income from business derived from within this state; that such business was unitary in character; and that the state was therefore justified in applying the formula method in arriving at the net income of appellant.

The sole question presented is whether the franchise commissioner should have adopted the separate accounting method in computing the franchise tax, or whether it was proper and legal for him to have used the formula system. If the first method is used, only the minimum tax of $25 would be due. Under the second method, which was actually applied here, the tax amounted to $3,798.43. The first method shows a loss in the California operations of appellant amounting to $82,851. Under the second, respondent showed that appellant enjoyed and received a net income from the business done in California amounting to $95,000. *In respect to net income, the two methods are some $177,851 apart.* Both methods are described in the stipulated facts above. The first is obviously based upon strict and accurate accounting procedure, while the second is the application of a set formula which has been approved in many jurisdictions in those cases where interstate operations are carried on, and where, from the nature of such operations, income cannot be properly allocated by separate accounting methods. Plain instances which justify the application of the formula method would be telegraph, telephone, railroad and express companies. If there is any evidence to sustain a finding that the operations of appellant in California, during the year 1935, contributed to the net income derived from its entire operations in the United States, it would seem as

though the method used was a proper one. Such income would be within the purview of the statute quoted above—"The portion of the net income derived from business done within this state." When the formula method is adopted by the taxing power, the burden of proof is upon the taxpayer to show that such method has been applied unreasonably and arbitrarily. (*Hans Rees' Sons* v. *State of North Carolina*, 283 U. S. 123.)

Appellant earnestly contends that the evidence is insufficient to justify the imposition of the formula. It points out that there is nothing in the stipulated facts which would justify a finding that it was doing a unitary business, and even if there were such evidence, the method used operated arbitrarily and unreasonably in respect to appellant's business. It is agreed by all parties that the formula of allocation to California of a portion of appellant's income from all sources, is proper, if the facts of the case justify the application of a formula. The question is not whether the formula used is fair and proper, but whether, under the facts here, there should be any allocation at all.

The factual structure of the case is relatively simple. Appellant is engaged in buying merchandise from manufacturers and others, and selling to retailers only. It does no manufacturing. It maintains a central buying division, but goods are shipped directly from the manufacturer to the houses in the several states, where the cost thereof and transportation charges are entered upon the books of the house. Further facts appear in the summary given above.

It is fundamental that jurisdiction to tax is dependent upon jurisdiction of the person or transaction sought to be taxed and that for a state to tax property on transactions beyond its jurisdiction is a denial of due process of law and of the equal protection of the laws. (*Frick* v. *Pennsylvania*, 268 U. S. 473.) Where, however, property located in two or more states derives a value from its unity of use, allocation of the composite value on a fair and reasonable basis will be sustained. The familiar illustration of this principle is in the assessment of railroad property. (*The Railroad Tax Cases*, 92 U. S. 575.) Referring to a unitary business, "That term is simply descriptive, and primarily means

that the concern to which it is applied is carrying on one kind of business—a business, the component parts of which are too closely connected to each other to justify division of separate considerations, as independent units." (*Maxwell* v. *Kent-Coffey Mfg. Co.*, 204 N. C. 365, 168 S. E. 397.) It has further been held that unity of *use* is something more than mere unity of *ownership*. (*Adams Express Co.* v. *Ohio*, 165 U. S. 194-222.) The allocation may be made by the application of a formula, which is based upon certain factors. The following excerpt from the stipulated facts describes the formula used and the manner of its application:

"In the year 1935, the operations of all houses of the Company produced a profit of $1,149,677. The additional tax assessed by the Franchise Tax Commissioner was predicated on the allocation to California of 8.1372% of the total income of the Company derived from all sources, such percentage having been determined by mathematical average of the percentages which (a) value of real and tangible personal property, (b) wages, salaries, commissions and other compensation of employees, and (c) gross sales, less returns and allowances, attributable to the San Francisco house bore to the corresponding items of all houses of the Company."

The fact that a corporation does business in more than one state does not necessarily justify the application of a formula to ascertain the tax. In *Hans Rees' Sons* v. *State of North Carolina, supra;* the court held:

"But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one State regardless of the extent to which it may be derived from the conduct of the enterprise in another State."

Where, however, a business is unitary in character, that is, where its separate parts cannot be fairly considered by themselves, and where the whole business in the several states derives a value from the unity of use, allocation of income upon a reasonable formula has been sustained. (*Bass, Ratcliff & Gretton* v. *State Tax Commission*, 266

U. S. 271; *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113.) Aside from the question as to the propriety of applying a formula here, and paramount over all other considerations, is the question whether or not it reasonably appears that a portion of the total net income of appellant was "derived from business done within this State." (Sec. 10 of Act 8488—fully quoted above.)

The only factor called to our attention by respondent which might point to a unitary business is the central buying power exercised by the headquarters of appellant in Illinois. The state argues that even though the California house lost money during the year 1935, the operations conducted during that year actually brought a profit to the corporation. They contend that the disposal of some $5,000,000 worth of merchandise during the time mentioned, increased the purchasing power of appellant, and thus permitted it to buy for its other houses, through volume purchases, at a price lower than it otherwise would have secured. It appears, however, that the parties have stipulated otherwise. We quote from the agreed facts: "A reduction in the volume of purchases made for the San Francisco house would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the Company."

Most of the cases cited by respondent, with one exception, involve corporations which are engaged in *manufacturing*. In those instances a manufacturing profit was made by the corporation before the merchandise was shipped to another state. This is true of the Underwood case, *supra*. Here, none of the merchandise was manufactured by appellant. It was engaged solely in buying and selling. There are cases where a corporation engaged in buying and selling has been held subject to the payment of income taxes in one of the states where it has been doing business. In *International Elevator Co.* v. *Thoresen*, 58 N. D. 776, 228 N. W. 192, a company which bought and sold grain was held liable for the payment of an income tax in the state of North Dakota. It bought grain in that state and shipped it for resale in other states. The corporation filed a return showing only income derived from sales in North Dakota. It failed to account for sales outside the state, and contended that only trans-

actions within the state should be considered in fixing its income. It showed that it had lost some $85,000 on transactions *within the state*. Its net profit from all its operations in several states amounted to $249,515.11. A tax of $2,937.98, computed by a formula, was upheld. The case was clearly one where a separate accounting system did not disclose the income received from shipment and sale of grain outside the state. The return by the elevator company included only income received from sales at North Dakota elevators. The case of *Montgomery Ward & Co.* v. *Kansas Tax Commission*, 151 Kan. 159, 98 Pac. (2d) 143, throws little light upon the question. No attempt was there made by the state to base a tax upon the net income of the corporation outside the state of Kansas. The only question was whether or not the corporation was entitled to charge against its Kansas income a proportionate share of certain expenses incurred outside the state. The court held in the affirmative.

Appellant relies strongly upon the case of *Standard Oil Co.* v. *Wisconsin Tax Commission*, 223 N. W. 85. Wisconsin taxes corporations on a basis very similar to our Bank and Corporation Franchise Tax Act and provides for allocation of income in a manner very like section 10. A company engaged in the production, refining and sale of petroleum products but engaged only in selling within Wisconsin was taxed on the basis of a statutory allocation of income from the entire operation. In that case it was shown that accurate accounting of the operations of the various branches existed. The court there held:

"In the enactment of the statute relating to the allocation of income of persons doing business within and without the State, the declared legislative purpose is to make a reasonable and equitable distribution of the taxpayer's income to the end that that part of the income justly assessable in the State of Wisconsin may be ascertained. The statute does not enjoin upon the Commission the use of that method which will produce the largest amount of taxable income but rather that method which will most justly apportion the income properly taxable in Wisconsin. Here it appears conclusively that it is possible to ascertain the income derived from business transactions in Wisconsin by the application

of proper accounting methods. . . . There are some operations which from their very nature produce an income which cannot be properly allocated by separate accounting methods, instances of which are the telegraph, telephone and express companies. They stand ready to serve whoever may apply for service and the entire operation constitutes a unit of service. *That is not the case with the manufacturing and sales business, particularly so where the accounts are so kept as to be readily separable.*"

We regard the foregoing case as very persuasive authority to the effect that a separate accounting method should be applied in the instant case.

We therefore conclude that the stipulated facts show that the company actually incurred a loss in California; that its California earnings could have been accurately ascertained without the necessity of recourse to any arbitrary formula, and that the use of such formula results in the imposition of a tax on income not earned in California, and therefore not subject to its taxing power.

The facts found do not support the judgment, and it is ordered that the judgment be reversed, with directions to the trial court to enter judgment in favor of appellant.

TUTTLE, *J.*

We concur:

PULLEN, *P. J.*

THOMPSON, *J.*

EXHIBIT "E".

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA, IN BANK

S. F. No. 16157

BUTLER BROTHERS, a Corporation, *Plaintiff-Appellant*,

vs.

CHARLES J. McCOLGAN, as Franchise Tax Commissioner of the State of California, *Defendant and Respondent.*

(Filed March 21, 1941, B. Grant Taylor, Clerk. By S. C. S., S. F. Deputy.)

This action was brought to recover an additional assessment made by the defendant as Franchise Tax Commis-

sioner under authority of the Bank and Corporation Franchise Tax Act (Statutes 1929, Ch. 13, as amended) for the taxable year 1936, based upon income for the year 1935, paid by plaintiff under protest. Judgment was entered in favor of defendant, and plaintiff appealed therefrom.

The cause was submitted upon an agreed statement of facts, which may be summarized as follows:

Plaintiff, Butler Brothers (herein called "the Company"), is an Illinois corporation, having its principal corporate office at Chicago. It is engaged in the wholesale dry goods and general merchandise business, purchasing from manufacturers and others and selling to retailers only. It operates seven wholesale distributing houses at Chicago, Jersey City, Baltimore, Minneapolis, St. Louis, Dallas and San Francisco. Each of these houses serves a separate trade territory. At each house stocks of goods are maintained, from which sales are made in its territory. Each house handles its own sales, and all solicitation, credit and collection arrangements in connection therewith, and keeps books of account showing the operations of the house. All sales in California were made from the San Francisco house and all receipts credited thereto.

Part of the operating expense of the houses is directly and exclusively incurred at the respective houses, including such items as labor, rentals, etc. The remainder consists of certain items of common expense such as executive salaries and corporate overhead and the expense of operating a central buying division and a central advertising division. These expenses are allocated to the respective houses on bases which, it is agreed, are in accord with recognized accounting practice, and the accuracy and propriety of such bases of apportionment are here conceded. For the year 1935 the amount of such allocated expense charged to the San Francisco house was $100,091, of which, it is agreed, approximately seventy-five per cent would have been incurred even though the San Francisco house was not operated. Except for such common expenses, each house is operated independently of each other house.

The company maintains a central buying division through which goods for resale are ordered, but such goods are shipped by the manufacturers to the houses for which

ordered, where the cost thereof and the transportation charges thereon are entered on the books of the house. No charges are made against any house for the benefit of the company, or any other house by reason of such centralized purchasing, but the actual cost of operating the central buying division is allocated to the houses, as stated in the preceding paragraph. By reason of the volume of purchases made by the company more favorable prices are obtained than would be obtainable in respect of purchases for the account of any individual house, but addition or reduction in the volume of purchases in an amount equal to the purchases made for the account of the San Francisco house would have no effect on the prices obtainable for the remaining houses.

The company computed its income from the operation of the San Francisco house by deducting from the gross receipts from sales of merchandise in California the costs of such merchandise, the direct expenses of the San Francisco house, and the apportioned share of common expenses previously described. According to this computation the San Francisco house operated at a loss of $82,851 for the year 1935. Within the time allowed by law a report showing this loss was made and the minimum tax of $25 was paid for the year 1936. In the year 1935 the operations of all houses of the company produced a profit of $1,149,677. The Franchise Tax Commissioner subsequently assessed an additional tax of $3,798.43, which, with interest amounting to $344.67, was paid under protest on September 16, 1938. The additional assessment was predicated on the allocation to California of 8.1372% of the total income of the company derived from all sources, such percentage having been determined by mathematical average of the percentages which the value of the tangible property, payroll and gross sales attributable to California bore to the corresponding items of all houses of the company. If an allocation is proper, use of the particular percentage here is not questioned.

The tax in question was levied under the provisions of section 10 of the Bank and Corporation Franchise Tax Act (General Laws, Act 8488, Vol. 2, p. 3858; Stats. 1929, p. 19:

amended by Stats. 1931, p. 2226; Stats. 1935, p. 965), which, so far as here involved, reads as follows:

"If the entire business of the bank or corporation is done within this State, the tax shall be according to or measured by its entire net income; and if the entire business of such bank or corporation is not done within this State, the tax shall be according to or measured by that portion thereof which is derived from business done within this State. The portion of net income derived from business done within this State, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, pay roll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation."

It is claimed by appellant that the method by which the tax was fixed and computed was unauthorized and unlawful, and that such method had the effect of taxing plaintiff on and in respect to income derived from sources beyond the jurisdiction of the State. This resulted, it is contended, in a denial of due process of law and of the equal protection of the law; in violation of the Fourteenth Amendment of the Constitution of the United States.

On the other hand, respondent contends that the tax was levied upon income from business derived from within this state, that the operations of the company are unitary in character, and that the formula for allocation of income used by the Franchise Tax Commissioner was lawful and proper in arriving at the net income of appellant from business done in California—computed to be approximately $95,000.

The sole question to be determined on this appeal is whether it is lawful and proper for the respondent, as Franchise Tax Commissioner, to insist upon use of the formula for allocation of income in a case such as this, or whether the company is entitled to use the separate accounting of its San Francisco house to determine its net

income in the State of California. The answer to this question depends entirely on the nature of the business conducted within and without the State by appellant, a foreign corporation. It is only if its business within this state is truly separate and distinct from its business without this state, so that the segregation of income may be made clearly and accurately, that the separate accounting method may properly be used. Where, however, interstate operations are carried on and that portion of the corporation's business done within the state cannot be clearly segregated from that done outside the state, the unit rule of assessment is employed as a device for allocating to the state for taxation its fair share of the taxable values of the taxpayer (Adams Express Co. *v.* Ohio State Auditor, 165 U. S. 194, 166 U. S. 185, 17 S. Ct. 604; Pullman's Palace Car Company *v.* Pennsylvania, 141 U. S. 18, 11 S. Ct. 876; State Railroad Tax Cases, 92 U. S. 575, 23 L. Ed. 663). In the early cases in which the unit rule first made its hesitating appearance there was always a physical link, a palpable unity of substance, a binding together by a system of rails or by telegraph wires. (State Railroad Tax Cases (1875), supra; Western Union Telegraph Co. *v.* Taggart (1896), 163 U. S. 1, 16 S. Ct. 1054, 41 L. Ed. 49). Then in Adams Express Co. *v.* Ohio State Auditor (1897), supra, the standard unity of substance was openly replaced by one of unity of use and management. This decision clearly recognized that in assessing tangible property for taxation, its value producing qualities in connection with other pieces of tangible property outside the state must be considered. If there is any evidence to sustain a finding that the operations of appellant in California during the year 1935 contributed to the net income derived from its entire operations in the United States, then the entire business of appellant is so clearly unitary as to require a fair system of apportionment by the formula method in order to prevent overtaxation to the corporation or undertaxation by the state. (Underwood Typewriter Co. *v.* Chamberlain, 254 U. S. 113, 41 S. Ct. 45). Such income would be within the purview of the statute quoted above—"The portion of the net income derived from business done within this State".

Preliminary to analysis and discussion of the cases cited by the parties as bearing on the issue involved in the instant case, we shall review briefly the relatively simple factual structure as it is logically reflected in the modus operandi of appellant's business. The company is engaged in buying merchandise from manufacturers and selling to retailers only. It maintains a central buying department outside the state. By its large scale purchasing activity, appellant concededly is able to buy at lower prices than would otherwise be possible, thus realizing a purchasing saving. But it is able to buy in large quantities only because it is able to sell in large quantities, so that it is apparent that the purchasing saving is made possible only because of the sales. Furthermore, it is pertinent to observe that the saving is not turned into profit until the sales are made. Thus, the purchasing activities and the sales activities are interdependent and supplement one another to form one single, unitary business. Appellant here calls attention to the fact that the parties stipulated that if an amount of sales equal to those of the San Francisco store were eliminated, the volume would not be reduced enough to affect the price at which appellant bought. On this ground appellant urges that the San Francisco store is the one which does not affect purchase price differentials. But, as the respondent urges, it also should be noted that it was stipulated that appellant bought at lower prices because of the great volume it obtained through having several stores. The weakness of appellant's argument is readily apparent when pursued to its logical conclusion. If the omission of the California sales would have no effect on the purchasing power, the omission of sales in an equal amount wherever made would likewise have no effect on the company's ability to purchase at a saving. Thus, by proceeding in turn from state to state, it could be shown that none of the sales in any of the states should be credited with the income resulting from the purchasing of goods in large quantities. It is our opinion that the sales made in each of the seven states in which appellant does business must be proportionately credited with the profits resulting from the purchasing power which such sales in the aggregate produce. Other salient factors indicating

the unitary character of appellant's business are the central advertising division and the central accounting and management division. The former enables appellant to spread its advertising cost over more stores and units and to secure its advertising at a lower cost per unit, thereby making possible advertising opportunities unavailable to a single store; as to the latter (central accounting and management department), the volume of business resulting from operation of the company's several stores permits better as well as more costly services of accounting and management to be available to each store, whereas if each were separately operated, services of such quality in all probability would be too expensive to be practicable.

The Supreme Court of the United States has repeatedly held that companies whose income has resulted from a series of transactions beginning with manufacture in one state and sales in another were unitary businesses. (Underwood Typewriter Co. *v.* Chamberlain (1920), 254 U. S. 113, 41 S. Ct. 45, 65 L. Ed. 165; Bass, Ratcliff & Gretton, Ltd., *v.* State Tax Commission (1924), 266 U. S. 271, 45 S. Ct. 82, 69 L. Ed. 282). While it is not clear from the record whether appellant manufactured any of its goods in the State of Illinois or elsewhere, it is conceded that appellant purchased most of its goods through the Illinois central purchasing arrangement. This central purchasing factor is completely analogous and comparable to the manufacturing activities in the Underwood Typewriter and Bass Ale cases, supra, wherein we find recognition of the principle that income from sales is attributable to the series of transactions from which the income is derived. Since these two leading cases involve the validity of allocation by applying a percentage formula to the entire income in order to determine the income taxable in a state where the business is only partly carried on, we shall consider them in some detail.

In Underwood Typewriter Co. *v.* Chamberlain, supra, the company manufactured its typewriters in Connecticut and sold them generally throughout the country. Using a statutory method of allocation (by assigning to the state that portion of the total income which the value of real and tangible personal property within the state bore to the total

value of such property within and without the state), Connecticut determined that 47 per cent of the company's net income was derived from property and transactions within the state. The company objected to the method of apportionment on the ground that only a little over 3 per cent of its net receipts was collected in Connecticut. The court upheld the Connecticut allocation for the reasons expressed in the following excerpt from the opinion at pages 120-121:

"* * * The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States. In this it was typical of a large part of the manufacturing business conducted in the State. The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a method of apportionment which, for all that appears in this record, reached, and was meant to reach, only the profits earned within the State. 'The plaintiff's argument on this branch of the case,' as stated by the Supreme Court of Errors, 'carries the burden of showing that 47 per cent. of its net income is not reasonably attributable, for purposes of taxation, to the manufacture of products from the sale of which 80 per cent. of its gross earnings was derived after paying manufacturing costs.' The corporation has not even attempted to show this; and for aught that appears the percentage of net profit earned in Connecticut may have been much larger than 47 per cent. There is, consequently, nothing in this record to show that the method of apportionment adopted by the State was inherently arbitrary, or that its application to this corporation produced an unreasonable result."

Here we have clear and concise expression of the only limitation on the use of a formula in the allocation or apportionment of income of a unitary business, to-wit, the formula must not be intrinsically arbitrary, and it must not produce an unreasonable result.

Bass, Ratcliff & Gretton, Ltd., *v.* State Tax Commission, supra, involved a British corporation engaged in brewing

and selling Bass' ale. Its brewing was done and a large part of its sales were made in England, but it had imported a portion of its product into the United States, which it sold in branch offices maintained in New York and Chicago. During the income year in question, the entire business was operated at a substantial profit, but the company, for federal income tax purposes, reported no income for that year from its business within the United States. Presumably this result was reached by computing its income under the separate accounting method. The Tax Commission of the State of New York assigned to New York that portion of the total net income which the value of certain specified classes of assets within New York bore to the total value of such assets within and without the state. The company resisted the tax on the ground that it derived no income from New York and that the action of the Commission was an attempt to assign to New York a portion of the company's income derived from business carried on outside the United States. The court, however, upheld the action of the Commission and at page 282 of its opinion expressed its views regarding the allocation of income of unitary businesses as follows:

"So in the present case we are of the opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places—the process of manufacturing resulting in no profits until it ends in sales—the State was justified in attributing to New York a just proportion of the profits earned by the Company from such unitary business. In Wallace v. Hines, 253 U. S. 66, 69, it was recognized that a State, in imposing an excise tax upon foreign corporations in respect to doing business within the State, may look to the property of such corporations beyond its borders to 'get the true value of the things within it, when they are part of an organic system of wide extent,' giving the local property a value above that which it would otherwise possess, and may therefore take into account property situated elsewhere when it 'can be seen in some plain and fairly intelligible

way that it adds to the value of the (property) and the rights exercised in the State.' This is directly applicable to the carrying on of a unitary business of manufacture and sale partly within and partly without the State."

Thus, it is apparent from the language of this case that with respect to a unitary business, income from the taxing state as determined by an allocation formula was controlling, where the statutory method of apportionment was not shown to be arbitrary or unreasonable.

In support of its argument that respondent's application of the formula would tax income from transactions taking place beyond the jurisdiction of California, appellant relies heavily upon Hans Rees' Sons *v.* State of North Carolina (1931), 283 U. S. 123, 51 S. Ct. 385, 75 L. Ed. 879. But an examination of the facts and legal principles involved therein reveals that there is nothing in that decision to support appellant's argument. The corporation was engaged in the business of tanning, manufacturing and selling leather products, and its principal manufacturing and supply house was located in North Carolina. Extensive sales and purchasing activities were carried on outside the state. The corporation offered proof which tended to show that for the years in question the average income having its source within the state was but 17 per cent of the total and actually showing that the percentage of its income attributable to North Carolina did not in any event exceed 21.7 per cent of the total, whereas the statutory formula, restricted to tangible property, had allocated to North Carolina approximately 89 per cent of the income. The opinion clearly recognized the necessity of using a method of apportioning to a state that portion of entire income which is "reasonably attributable to the processes conducted within the borders of that State," but because the particular statutory formula employed, consisting simply of the property factor, attributed to North Carolina a percentage of income "out of all appropriate proportion to the business transacted by the appellant in that State," the court refused to approve the result reached by the formula. Careful analysis of the underlying legal principles considered in the Hans Rees' case compels us to conclude that it, like the

Underwood Typewriter and Bass Ale cases, supra, recognized that where a business is unitary in character, so that its separate parts cannot be fairly considered by themselves and the whole business in the several states derives a value from the unity of use, allocation of income upon a reasonable formula is properly sustained.

The latest expression of the Supreme Court of the United States on this subject brought to our attention is North American Cement Corporation *v.* Graves (1936), 269 N. Y. 507, 199 N. E. 510; 243 App. Div. 834, 278 N. Y. S. 920; 299 U. S. 517, 57 S. Ct. 311, wherein it is significant to note that Bass, Ratcliff & Gretton, Ltd., *vs.* State Tax Commission, supra, was cited in support of its holding that income from the taxing state as determined by an allocation formula was controlling, although the taxpayer showed that by separate accounting much less income would be allocated to the taxing state. The United States Supreme Court and the New York Courts from which the taxpayer appealed all decided the case with memorandum opinions, so the facts must be obtained from the record in the case (Volume 2253, United States Supreme Court Records). The taxpayer, a foreign corporation, owned and operated three cement plants and one lime plant and sold the products thereof. Two of the cement plants were in New York, one was in Maryland and the lime plant was in West Virginia. The corporation operated its four plants separately and sold their products in separate districts, kept separate accounts for them, and sold very little of the output of the West Virginia and Maryland plants in New York. The Tax Commission allocated the net income of the corporation by a one factor formula (property factor) for the income years 1925, 1926, 1927 and 1929. By this means large incomes were allocated to New York for each of those years. The corporation, by an elaborate separate accounting system, showed that for 1925 the New York income was much less than that allocated to that state by the formula, and that for 1926, 1927 and 1929 the corporation sustained large losses from its New York business instead of deriving from New York the income allocated to it by the formula. In the face of this evidence the Supreme Court of the United States, affirming the New York Court of Appeals and Ap-

pellate Division, Supreme Court, held that the results of the formula were controlling and upheld the assessment thereon.

The significance of this decision on two points involved in the instant case is readily apparent: (1) it holds that the operations of four separate manufacturing plants, one of them making a different product from different materials than the others, are so interrelated as properly to be treated as *unitary;* (2) it holds that separate accounting in accordance with recognized accounting practice is insufficient evidence to disprove the propriety and presumption of fairness of formula allocation. On both points this decision is contrary to Standard Oil Co. v. Wisconsin Tax Comm. (1929), 197 Wis. 630, 223 N. W. 85, on which appellant strongly relies in asserting that the results of its separate accounting must be accepted by respondent as tax administrator. However, careful examination of the factual situation in this Wisconsin case reveals a peculiar distinguishing allocation factor which undoubtedly exerted a strong influence on the result reached by the court there.

In Standard Oil Co. v. Wisconsin Tax Com., supra, the plaintiff company produced, refined, transported and marketed petroleum products in eleven mid-western states, and its property within Wisconsin consisted principally of tanks and filling stations required to supply the Wisconsin demand. Fifty-four per cent of the oil stored in these tank farms was sold to Wisconsin and forty-six per cent without the state. Plaintiff company did practically no manufacturing in Wisconsin. The controversy arose as to the manner in which that part of its income properly taxable in the state of Wisconsin should be ascertained. The Tax Commission used a ratio method provided in the statute for unitary business transactions conducted within and without the state. The company contended that its income should be ascertained by the allocation and separate accounting method by which the Wisconsin business was charged *at the market price* with all products received by it, with the expense of transacting the business, including a proper allocation of general or overhead expenses and office accounting, that there should be credited to Wisconsin the gross amount received from sales of goods within the state,

and that the difference constituted the taxable income of plaintiff company. The court upheld the plaintiff company's contentions. The distinction to be noted here differentiating this Wisconsin situation from the instant case is the fact that the products furnished to the Wisconsin business were charged at "*market value*" rather than at cost. *Market value* (at wholesale) included reasonable *profit*, and such profit became income to the company in the outside states. This amounted in effect to allocation of income as between Wisconsin and the other states. That the plaintiff company's arbitrary method of assigning a fictitious market value at which the selling division was deemed to have "bought" the oil from the refining division greatly impressed the Wisconsin court and furnished reason for its distinction of the Underwood Typewriter case, supra, appears from the following language at page 639 of the opinion: "Nor do we find anything in Underwood Typewriter Company v. Chamberlain, 254 U. S. 113, 41 S. Ct. 45, inconsistent with our conclusion in this case. There, there was no separation on the basis of market value between the operations of the manufacturing department and the sales department as there is in this case. We perceive no reason why, under the facts in this case, the profits derived from the sales operations should not be ascertained, so far as plaintiff is concerned, as they would be if the sales operations were conducted by a separate corporate entity." Whether the Wisconsin court by its decision placed too much emphasis on the value of fictions is not our concern here; suffice it to say that the Wisconsin court manifestly sanctioned the practice of charging the products to the Wisconsin end of the business at *wholesale market prices* in determining income derived in Wisconsin. The distinction between *market price* and *cost* cannot be ignored; the former includes profits and the latter does not; and it is this differentiation which decidedly limits the applicability of the Wisconsin case to the instant factual situation.

The unitary character of the buying and selling business has been recognized in International Elevator Co. v. Thoresen (1929), 58 N. Dak. 776, 228 N. W. 192, and Great Atlantic & Pacific Tea Co. v. Grosjean (1937), 301 U. S. 412, 57 S. Ct. 772, 81 L. Ed. 1193. In the Thoresen case,

supra, plaintiff company operated a line of grain elevators, about half of which were in Montana and the other half in North Dakota. The company's income was derived chiefly from the sale, outside the state, of grain bought within North Dakota, and the question was whether North Dakota could assess a tax upon any part of the income from the sales outside the state. Like appellant here, the plaintiff company there tried to apportion its income by separate accounting. That procedure was held improper and allocation of income was sanctioned to North Dakota wholly out of proportion to the receipts within North Dakota. On the mere basis of accounting figures the instant case is less extreme than the North Dakota case, where the net income allocated to the taxing state by the formula exceeded the gross income allocated to the state by separate accounting; yet, in such situation because of the unitary nature of the business, the Supreme Court of North Dakota held that the transactions of buying constituted an essential part of the transactions from which the income collected outside the state was derived.

The Great Atlantic & Pacific Tea Co. case, supra, dealing with a state chain store tax act, bears on the instant issue in that it was there held that the out-of-state stores and central buying and advertising of the buying and selling corporation gave the within-the-state stores advantages which they otherwise would not have had and justified a chain store tax on the within-the-state stores which would otherwise have been, from a constitutional viewpoint, discriminatory. The manifest parallelism between that case and the instant one needs no other comment than the observation that the decision of validity in that case is based on the same reason as that for treating business as unitary in allocating income.

The formula method of allocating or apportioning income in the case of a unitary business was approved by this court in Matson Navigation Co. v. State Board of Equalization, 3 Cal. (2d) 1; affirmed 297 U. S. 728; 56 S. Ct. 553, 80 L. Ed. 1010. In that case it was established that the power of California to tax foreign corporations measured by their net income and the provisions of section 10 of the Bank and Corporation Franchise Tax Act are co-extensive in scope,

and in this connection this court there held that section 10 measures the tax by income from California and excludes from the measure "income from business done entirely outside the State * * *." (3 Cal. (2d) 1, 8). In such case as the instant one, allocation of income to the various states in which the business is done by means of a formula that gives weight to the various factors such as property, services of employees and sales, which are responsible for the earning of income, appears entirely reasonable. To rebut the presumption that the formula produced a fair result, "the burden is on the taxpayer to make oppression manifest by clear, cogent evidence." (Norfolk & Western Ry. Co. v. Maxwell (1936), 297 U. S. 682, 688, 56 S. Ct. 625). In considering the implications of the formula in the last-mentioned case, the Supreme Court of the United States, speaking through Mr. Justice Cardozo, also said at page 688: "* * * a taxpayer does not escape the application of the statute by evidence directed to only one of the related terms. The evidence to be effective must be directed to each of them alike, for only thus can the assumed relation between them be proved to be unreal. * * *" In the case at bar appellant has not furnished any explanation of why its California business differs so from the average that the formula produced an erroneous result. Here there has been only an assertion that a loss incurred in this state. As appellant has failed to show a variance from normal in either the California sales, property or payroll, or in either expenses or revenue, it is our conclusion that appellant has not upheld its burden of proof, for in order to overthrow a formula the taxpayer must introduce such evidence and the evidence must go to each element of the formula equation. (Norfolk & Western Ry. Co. *v.* Maxwell, supra).

In accordance with the foregoing analysis it is our opinion that the unitary nature of appellant's business is definitely established by the presence of the following circumstances: (1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in its centralized executive force and general system of operation. The reasonable and equitable character of this state's formula, based on factors properly reflecting the relative contribution of the

activities in the various states to the production of the total unitary income so as not to contravene the restrictions implicit in the Fourteenth Amendment against taxing property outside the state, was recognized in Matson Navigation Co. *v.* State Board of Equalization, supra. Accordingly, respondent correctly applied the formula method of apportionment to determine California's portion of appellant's income from the business carried on within and without the state.

Judgment affirmed.

CURTIS, *J.*

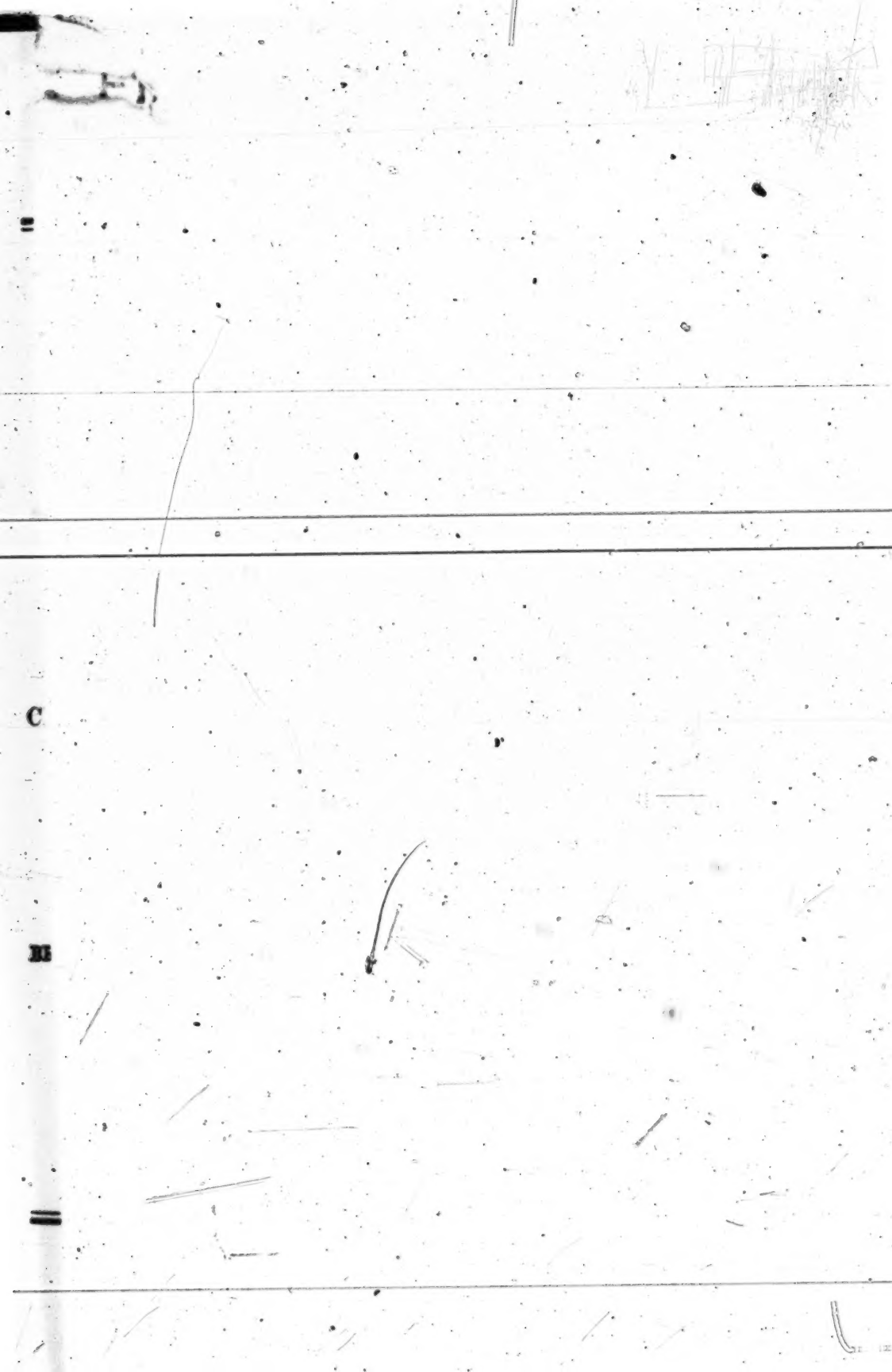
We concur:

GIBSON, *C. J.*;

SHENK, *J.*;

CARTER, *J.*

TRAYNOR, *J.*, took no part in the consideration or decision of this case.



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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1941.

No. 283

BUTLER BROTHERS, A CORPORATION,
Appellant,

vs.

CHARLES J. McCOLGAN, AS FRANCHISE TAX COMMISSIONER OF THE STATE OF CALIFORNIA,
Appellee.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA.

BRIEF OF APPELLANT IN OPPOSITION TO APPELLEE'S MOTION TO DISMISS OR AFFIRM.

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MAY IT PLEASE THE COURT:

Pursuant to the provisions of Rule 12, paragraph 3, Appellee herein has filed a motion to dismiss or affirm. Appellant files this brief in opposition to such motion as provided in Rule 7, paragraph 3.

The asserted ground for Appellee's motion is that there is no substantial Federal question presented for the reason that "the questions presented have been so thoroughly foreclosed by previous decisions of this court as to leave no debatable ground" for attacking the decision of the court below.

The facts stipulated to by the parties to this suit are set out at some length in Appellant's Jurisdictional Statement heretofore filed (p. 11 *et seq.*), and we ask the Court to consider the facts as there stated, or, if need be, the stipulation of facts as it appears in the record, rather than the facts as stated in Appellee's present motion.

Appellee's motion seems to be premised upon the theory that the facts stipulated by the parties and adopted by the trial court as its findings of fact do not show or tend to show that Appellant's operations in California resulted in a loss in fact. Premised upon such erroneous theory Appellee contends that the instant case does not come within the principles announced in *Hans Rees' Sons, Incorporated* v. *North Carolina*, 283 U. S. 123. Appellee further contends in effect that the *Rees* case has been overruled by *North American Cement Corporation* v. *Graves*, 299 U. S. 517, which latter case follows and is based upon the *Bass* and *Underwood* cases.

The judgment of the court below upholds the validity of an apportionment method of taxation and the consequent validity of the statute pursuant to which such apportionment method is applied—thereby establishing for tax purposes a "net income" in California although the facts, as stipulated, show that Appellant had no "net income" in California, but rather a loss. As pointed out in our Jurisdictional Statement a loss in *fact* of $82,851 has been converted by use of the apportionment method into a "net income" of $93,551.50. It would seem obvious that under the holding in the *Rees* case an apportionment method of taxation, albeit fair on its face, and a taxing statute, also fair on its face, may not be applied so as to result in any such unreasonable and arbitrary manner. No such apportionment method and no such statute will be permitted to create taxable income where none exists in fact.

On page 7 of its motion and argument Appellee makes the statement that there has been no explanation as to

"why Appellant's method of operation should produce a loss in California while it was producing a large income from its total operations." The court below in its opinion (Jurisdictional Statement, p. 55) says:

> "In the case at bar Appellant has not furnished any explanation of why its California business differs so from the average that the formula produced an erroneous result. Here there has been only an assertion that a loss occurred in this State."

Such statements are naive to say the least. It is the same as saying that every branch or division of a company's business must be profitable. However, as in the instant case, it is not a question as to why Appellant's San Francisco House was unable to operate at a profit. The only material fact is that according to the record facts it did operate at a loss. Notwithstanding the court's statement above quoted that in the instant case there has been only an "assertion" that a loss occurred in California we nevertheless read the opinion of the California Supreme Court as not seriously questioning but that the facts as stipulated show, or tend to show, that a loss resulted in California and as not turning upon any factual question as to whether such a loss resulted. However, in view of the court's statement we take the time to refer to the record facts. Appellant's income from the operation of its San Francisco House was computed

> "by deducting from the gross receipts from sales of merchandise in California, determined as indicated in paragraph 2 of the stipulation, the costs of such merchandise, determined as indicated in paragraph 3, the direct expenses of the San Francisco house referred to in paragraph 3, and the indirect expense allocated to the San Francisco house in the manner described in paragraph 4. According to this computation, the San Francisco house operated at a loss of $82,851 during the year 1935." (Jurisdictional Statement, p. 13; Stipulation of Facts, Par. 5.)

The gross receipts in question are the amounts paid by the customers for the goods sold from the San Francisco house out of stocks maintained there—all receipts from sales made in California being credited to the San Francisco house. (Jurisdictional Statement, p. 12; Stipulation of Facts, Par. 2.)

The cost of the merchandise is the actual cost thereof plus transportation charges — the merchandise being shipped directly by the manufacturers to the San Francisco house, and no charge being made against such house for the benefit of the company or any other house by reason of the centralized purchasing. (Jurisdictional Statement, p. 12; Stipulation of Facts, par. 3.) The direct expenses of the San Francisco house are those which are directly and exclusively incurred at such house, including such items as labor, rentals, and similar expenses. (Jurisdictional Statement, p. 12; Stipulation of Facts, par. 3.) The indirect expenses which are allocated in part to the San Francisco house are:

> "Certain items of expense which are incurred and paid by the Company for the benefit of all the houses, the costs of which are allocated to the respective houses. * * * For the year 1935 the amount of such allocated expense charged to the San Francisco house was $100,091, of which 75 per cent would have been incurred by appellant even though the San Francisco house was not operated." (Jurisdictional Statement, p. 13; Stipulation of Facts, par. 4.)

It also appears in said paragraph 4 of the Stipulation that no question exists as to the accuracy of the amounts of such common expense or to the method of allocation employed which is in accordance with recognized accounting practices; that the accuracy and propriety of the basis of allocation of such common expenses for the year 1935 are admitted and that included in such expenses

> "are executive salaries, certain accounting expenses, the cost of operating a central buying division and a

central advertising division." (Jurisdictional Statement, p. 13; Stipulation of Facts, par. 4.)

Said paragraph 4 further states that except for such common expenses each house is operated independently of each other house. (Jurisdictional Statement, p. 13.)

Under such a Stipulation of Facts Appellant's loss in California is established, not by mere assertion, but by actuality—by the "evidence" which this Court in the *Rees* case said had been produced there but which it said was lacking in the *Underwood* and *Bass* cases.

That an apportionment formula, however it is set up, is an approximation only, and will yield to a more accurate determination of income is established by all the cases decided by this Court where the question of the validity of an apportionment method is involved. And this is true even in *Norfolk & Western Ry. Co.* v. *North Carolina*, 297 U. S. 682, one of the cases strongly relied upon by the court below. That case involved an apportionment of income based upon mileage within the state compared with the total mileage of the company. While such apportionment method was there sustained for the reason that the evidence was not sufficient to show that such method did not result unreasonably or arbitrarily, this Court clearly recognized that if income within the taxing state was susceptible of determination by some method other than by an apportionment method such other method should be followed. In that connection this Court said, 297 U. S. at page 685:

> "Taxpayer and state would be swamped with administrative difficulties if left to struggle through every case without the aid of a formula of ready application. In the perplexities besetting the process of assessment the statute is the outcome of a reasonable endeavor to arrive at a proportion of general validity. • • •
>
> "• • • A segment of the line may operate under handicaps resulting from the nature of the traffic, the topography of the country, the maladjustments or inadequacy of passenger or freight tariffs in one dis-

trict or another. As applied to such a segment the average mileage prorate of the entire railway system may be an arbitrary test of the relation between revenue and expenses. * * * If this is made to appear with an ensuing burden on the taxpayer grossly in excess of the results of a more accurate apportionment, the statute to that extent is an unconstitutional endeavor to tax the income of a business in another jurisdiction. *Hans Rees' Sons* v. *North Carolina, supra.*"

We have said above that we do not read the opinion of the court below as turning upon any factual question as to whether a loss did or did not result in California. We think this view of the opinion is amply supported by the statement of the court below as to the question presented for determination (Jurisdictional Statement, p. 44):

"The sole question to be determined on this appeal is whether it is lawful and proper for the respondent, as Franchise Tax Commissioner, to insist upon use of the formula for allocation of income in a case such as this, or whether the company is entitled to use the separate accounting of its San Francisco house to determine its net income in the State of California. *The answer to this question depends entirely on the nature of the business conducted within and without the State by appellant, a foreign corporation.* It is only if its business within this State is truly separate and distinct from its business without this state, so that the segregation of income may be made clearly and accurately, that the separate accounting method may properly be used. Where, however, interstate operations are carried on and that portion of the corporation's business done within the state cannot be clearly segregated from that done outside the state, the unit rule of assessment is employed as a device for allocating to the state for taxation its fair share of the taxable values of the taxpayer." (Citing cases.)

And further:

"If there is any evidence to sustain a finding that the operations of appellant in California during the year 1935 contributed to the net income derived from

its entire operations in the United States, then the entire business of appellant is so clearly unitary as to *require* a fair system of apportionment by the formula method in order to prevent overtaxation to the corporation or undertaxation by the state." (Italics ours.)

The court then, as we have pointed out, held Appellant's business to be "unitary" and therefore concluded (contrary to the *Rees* case) that an apportionment method became mandatory. It is inconceivable how the California Supreme Court could have so held in the face of the *Rees* case that the fact that the business is "unitary" is not the controlling factor. And when we see that, as in the instant case, the business is not even a "unitary" one in the concept of that term expressed in the *Rees* case, the case is even a more flagrant one of the taxation of property or income or business not within the taxing power of the State of California. In the instant case the ultimate gain of Butler Brothers is not derived from the entire business. Its gain is an aggregate of the gain or loss of each of its branch Houses. And where a loss has resulted in a given branch House as in California the basis for the application of an apportionment method does not exist.

The California court's statement quoted above is also completely negatived by the *Norfolk & Western* case which it itself cites and relies upon. We can hardly conceive of any division of the business which is less "separate and distinct" from the company's out-of-the-state business than the railway mileage of the Norfolk & Western in North Carolina. And yet this court recognized that even in the case of such a rail carrier a statutory formula must yield to the requisite factual showing as to the "income" of the lines within the state.

In the light of Appellant's method of doing business and the separateness of the operations of its various houses including the San Francisco house, we can think of no more

accurate method for determining the results of the operations of any of the houses, including those of the San Francisco house, than the method followed by Appellant in the instant case—a method not devised merely for tax purposes but devised and used in the actual conduct of its business affairs. That this latter statement is true appears from the Stipulation of Facts with reference to the keeping of separate accounts at each house and as to the items entered therein. See Stipulation of Facts, paragaphs 2, 3 and 4; Jurisdictional Statement, pp. 12-13.

Whether such method for the determination of the income at Appellant's various houses be deemed "separate accounting" or otherwise, the essential fact is that such method is an accurate method, and lends itself with reasonable certainty to a determination of the actual results of the operations of the several houses. Such being the case, there is no room for the application of an apportionment method.

On page 7 of its motion and argument Appellee attempts to distinguish the *Rees* case with the statement that the evidence there tended to show that the manufacturing was only slightly responsible for the company's profits, whereas the formula had the effect of attributing nearly the entire profit to the state of manufacture. It is stated in the opinion of this Court in the *Rees* case, 283 U. S. at page 128, that there was allocated to North Carolina the following percentages of the company's total income; 83 per cent for 1923; 85 per cent for 1924; 66 per cent for 1925; and 85 per cent for 1926. The evidence offered by the company which was excluded by the trial court tended to show that about 17 per cent of the company's income was attributable to the manufacturing operations in North Carolina. (See also page 134 of the opinion.)

In the instant case it is true that the apportionment method allocated to California some 8 per cent of Appel-

lant's total income. (Jur. St., p. 13.) And it is upon this fact that Appellee argues that the income allocated to California under the apportionment method here applied did not allocate to California an unreasonable portion of Appellant's total income. But that, we submit, is not the controlling factor. As stated, the apportionment method here applied has resulted in converting an actual loss of $82,000 into a net profit of $93,000. The apportionment method has simply created out of nothing additional income in California of some $175,000. The question for decision is whether or not an apportionment method and the statute itself authorizing such method can be applied so as to bring about such a result. As shown by the *Rees* case, an apportionment method will and must yield to a more accurate method of determining income.

On page 6 of Appellee's motion and argument he says that this Court has held that the formula method of allocation cannot be accepted in part and attacked in part. Reference is made to *Norfolk & Western Ry. Co.* v. *Maxwell*, 297 U. S. 682. Appellee's contention in this respect differs somewhat from the contention of the California Supreme Court also based upon the *Norfolk & Western* case. The court below said (Jurisdictional Statement, p. 55):

> "As appellant has failed to show a variance from normal in either the California sales, property or payroll, or in either expenses or revenue, it is our conclusion that appellant has not upheld its burden of proof, for in order to overthrow a formula the taxpayer must introduce such evidence and the evidence must go to each element of the formula equation."

What Appellee means by his statement is that there were certain expenses in the way of general overhead and the like which necessarily had to be divided up or allocated among the various branches or divisions of Appellant's business, which expenses were allocated upon a percentage

basis. If Appellee's contention in this regard were correct it would never be possible to determine a separate income in any one state in the case of a corporation doing business in various states under a single management or control inas much as there must always be in such cases some sort of an allocation of the common expense among the various states.

In view of Appellee's contention and of the court's statement, we take time to state what we understand the holding in the *Norfolk & Western* case to have been. In that case taxable net income of interstate railways was based upon the proportion of mileage within the state to the railroad's total mileage. Under the apportionment formula the "gross revenues" were first determined by the mileage ratio and the gross expenses, also determined by the mileage ratio, were then deducted. The railroad in question accepted the gross revenues determined upon such mileage ratio but claimed that the gross expenses determined by such ratio were substantially less than the expenses of the North Carolina mileage. As to whether the expenses of the North Carolina mileage were more or less than those as determined by the statutory formula this Court said (297 U. S. at page 686) that there was evidence in the record giving support to the company's position and that up to that point the company took upon itself the burden of making out a case for the rejection of the formula. This Court then said, however (p. 686):

> "There, however, it stopped, declining to go further. From the testimony of its witnesses we learn that actual expenses were greater in North Carolina than the average expenses apportioned to that state on the basis of the ratio between state and system mileage. We learn nothing from the witnesses as to the ratio between revenues, average and actual. For all that appears in the case developed by the Railway actual gross revenues in North Carolina may have been so far in excess of average gross revenues com-

puted under the statute as to neutralize the discrepancy between actual and average costs of operation. If such a counterbalance exists, appellant has not been injured through the application of the formula."

It then appeared that the state itself had offered evidence that through the application of the formula the gross revenues of the North Carolina mileage were underestimated to a greater extent than the operating expenses. On this branch of the case the company's witnesses claimed that there was no method of allocating revenues with any greater approach to certainty than by means of the mileage ratio. As to that testimony this Court said that either for that reason or some other the witnesses had not made an attempt to ascertain receipts, no matter how approximately, by any other method as assuredly they would have tried to do if the statutory formula had been abolished altogether. The trial court found that from the evidence the actual gross operating revenues if determined otherwise than by the formula "would be increased by a much greater proportion than the operating expenses in North Carolina are increased over the operating expenses determined by the use of the statutory formula." That finding was approved by the Carolina Supreme Court. This Court then went on to say that the taxpayer attacking the formula could not attack the prorating on the expense side and offer no evidence as to the revenue side, and that the evidence

> "to be effective must be directed to each of them alike, for only thus can the assumed relation between them be proved to be unreal. This taxpayer disclaims the duty and even the endeavor to respond to such a test, It varies the numerator of the fraction while accepting the denominator."

Had Appellant in this case applied an allocation formula to its total expenses at all houses, and at the same time insisted upon using as the gross revenue of the San Francisco house only the actual receipts from sales made at

that house, or conversely if it had applied an allocation formula to its total sales or gross receipts and then used the actual expenses of the San Francisco house in determining its California income, a question would have been presented quite different from that presented by the present record. In the instant case both gross revenue and expense have been determined by the actualities of the operations of the San Francisco house, excepting only to the extent of the necessity of allocating to the San Francisco house as additional expense a reasonable proportion of the common expenses. While perhaps such common expenses could have been allocated upon some basis other than that actually employed, nevertheless there is no issue between the parties in that regard in view of the stipulation:

> "That the accuracy and propriety of the basis of allocation of such common expenses for the year 1935 are admitted." (Jurisdictional Statement, p. 13; Stipulation of Facts, par. 4.)

It is further to be noted that a simple arithmetical computation discloses that in view of the total sales of the San Francisco house amounting to $5,206,000 (Jurisdictional Statement, p. 14) and the operating loss of $82,851, the total operating costs must have amounted to $5,288,851, of which the allocated common expense amounted only to $100,091—less than 2 per cent of the total operating expense of the San Francisco house.

It was also stipulated that of the allocated common expense amounting to $100,091, 75 per cent would have been incurred even had the San Francisco house not been operated. (Jurisdictional Statement, p. 13.) Were this 75 per cent, or $75,000, eliminated from the San Francisco account entirely Appellant would still have incurred a loss at that house. Only by eliminating all of the allocated common expense would a "net income" result—and then only in the amount of $18,000, the difference between the $82,851 of loss as shown and the amount of the allocated common

expense of $100,091. However, as we see it, to eliminate from the San Francisco accounts any part of the overhead or other common expense would be not only to distort the income of that house, but also to distort the income of the other houses inasmuch as the other houses would have to absorb the whole of such expense.

Under the facts of this case the *Norfolk & Western* case does not support Appellee's position, or the decision of the court below. Certainly what this Court had to say in that case about a partial use of a statutory apportionment method in determining the income to be taxed by the taxing state has no relevancy to the instant case.

We also call this Court's attention to the fact that the court below, whether inadvertently or not, misstates the rule of even the *Underwood* and *Bass* cases, for in its opinion (Jurisdictional Statement, p. 48) it says that the only limitation on the use of a formula in the allocation or apportionment of the income of a unitary business is that the "formula must not be intrinsically arbitrary *and* it must not produce an unreasonable result." (Italics ours.)

The court thus states the limitation conjunctively instead of disjunctively as the decisions of this Court hold. It is not necessary that there be *both* an intrinsically arbitrary formula and an unreasonable result for the formula itself need not be inherently arbitrary if its application does not produce an unreasonable result. This is clear from the quotation from the opinion of this Court in the *Underwood* case immediately preceding the statement of the court below to which we have just referred. (Jurisdictional Statement, p. 48.)

Appellant's total income for 1935 amounted to but $1,149,000. It is to this income that the Appellee's percentage allocation was applied. But in the determination of that income there was taken into consideration the $82,000 loss in California. The result is that the remaining

houses produced an income of $1,231,000, and it is upon that income that the other states are entitled to impose taxes. And in producing that income the other houses received credit for their share of the Appellant's aggregate buying power by having their goods charged to them at the actual cost paid therefor plus transportation—just as in the case of the San Francisco house. The California Supreme Court recognizes the right of the other states to include as part of the income which they may tax that portion accruing from the favorable purchases to which they as well as California have contributed. If, however, California by a process of apportionment is given a taxable income of $93,000 the result is necessarily an addition to the Company's total income of $175,000—making such income $1,324,000 instead of the $1,149,000. In other words, by the action of the California Supreme Court Appellant's total net income is arbitrarily increased to the extent of $175,000 of income which is nonexistent in fact. Viewed in this light Appellant would not only be subjected to a double tax upon the same income but even more clearly California is enabled to tax income which properly and legally belongs in some other state.

On page 8 of its motion and argument Appellee suggests that in the case of a *franchise* tax the tax may be measured by a percentage allocation of the taxpayer's total income without regard to the factual situation. The argument is necessarily, therefore, that the decision in the *Rees* case does not apply in the case of a *franchise* tax as distinguished from an income tax.

In *Underwood Typewriter Co.* v. *Chamberlain*, 94 Conn. 47, 108 Atl. 154, the statute in terms imposed a tax upon the net income of the corporation to be apportioned to the state upon the designated basis of allocation. The state contended that the tax was in the nature of an excise tax. Others contended that the tax was a property tax, and still others contended that the tax was an income tax. The

Connecticut court held that the tax was an excise tax levied upon the privilege of doing business in the state—even though the tax itself was measured by a percentage of the corporation's total net income. In the same case in this Court, *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113, in considering the objection that the tax was imposed upon income arising from business conducted beyond the boundaries of the State of Connecticut, this Court said:

> "In considering this objection we may lay on one side the question whether this is an excise tax purporting to be measured by the income accruing from business within the state or a direct tax upon that income; for the 'argument upon analysis resolves itself into a mere question of definitions and has no legitimate bearing upon any question raised under the Federal Constitution.'" (254 U. S., p. 120.)

The New York statute involved in the *Bass* case and *North American Cement* case is clearly an excise tax. Neither of those cases was decided upon any distinction between an excise tax and an income tax. The North Carolina statute involved in the *Rees* case was in terms a tax upon net income, although it applied to a foreign corporation "doing business" within the state. See *Maxwell* v. *Hans Rees' Sons, Incorporated*, 199 No. Car. 42, at p. 47. The North Carolina court, in upholding the validity of the tax there involved, said that the method of measuring the tax (the apportionment method) on "net income" had been approved by this Court in the *Underwood* case, and that the Connecticut statute construed in that case was substantially identical with theirs. Apparently, therefore, the North Carolina statute must be taken to be an excise or franchise tax and not an income tax.

The California statute involved in the instant case is in terms an excise or franchise tax measured by net income and has been so considered by the California Supreme

Court. *Matson Navigation Co.* v. *State Board*, 3 Cal. (2d) 1, 43 Pac. (2d) 805, affirmed, *Matson Navigation Co.* v. *State Board*, 297 U. S. 441; *Pacific Co.* v. *Johnson*, 212 Cal. 148, 298 Pac. 489, affirmed *Pacific Co.* v. *Johnson*, 285 U. S. 480. Before any distinction can be made, therefore, between an excise or franchise tax on the one hand and an income tax on the other, and before the *Rees* case can be distinguished on that ground, it must be shown that the *Rees* case was dealing with an income tax and not an excise or franchise tax, and that this Court intended in the *Rees* case to make such distinction. We submit, however, that in the *Rees* case this Court intended no distinction between an excise or franchise tax on the one hand and an income tax on the other, and that it was following in that regard what it had said in the *Underwood* case that the question must be decided without regard to any such distinction. We are frank to say, however, that if any such distinction is now to be made, and if the question raised in the instant case for decision is to be briefed or argued upon the basis that there is such a distinction then there is added reason for this Court's taking jurisdiction, and Appellee's motion and argument affirmatively shows that a very substantial question exists which should be decided.

The court below states in its opinion (Jurisdictional Statement, p. 54) that the "formula method of allocating or apportioning the income in the case of a unitary business was approved" by that court in the *Matson* case, and affirmed by this Court. We do not believe this statement of the court to be accurate. The *Matson* case involved two California corporations and the question there was as to whether the statutory formula should be applied to a base which included receipts from interstate and foreign commerce. The companies contended, first, that the statute should not be interpreted as including such receipts in the tax base, and, secondly, that if they were to be so included

the statute was void. The California court held that the tax base should include receipts from interstate and foreign commerce and its decision in that regard was affirmed by this court. There is no such question in the instant case. The Stipulation of Facts here shows that sales were made from the San Francisco house throughout the territory which was attributable to it. In other words, sales were made in states other than California. All of the receipts from such sales were included in the San Francisco gross receipts in determining the net income or loss in California. No claim has ever been made by Appellant that the receipts of the San Francisco house derived from sales in interstate commerce should be excluded. The difference between the *Matson* case and the present case is clearly recognized in the opinion of this Court in the *Matson* case in its discussion of the *Rees* case, 297 U. S. at pages 444-5. As this Court there said, the question in the *Rees* case "was as to the apportionment of income to the taxing state," and that the controversy in the *Matson* case concerned the amount "to be paid for the privilege of using in California corporate franchises granted by that state" to the companies, and that "no question of apportionment is here involved."

Finally in its motion and argument, at page 8, Appellee takes us to task for having pointed out in our Jurisdictional Statement that the California Supreme Court, in arriving at its conclusion, had indulged in certain inferences and presumptions contrary to paragraph 12 of the stipulation. (Jurisdictional Statement, p. 7.)

We refer, by way of illustration, to such statements in the opinion of the court below as the following:

> "If the omission of the California sales would have no effect on the purchasing power, the omission of sales in an equal amount wherever made would likewise have no effect on the company's ability to purchase at a saving. Thus, by proceeding in turn from state to state, it could be shown that *none of the sales in any of the states* should be credited with the in-

come resulting from the purchasing of goods in large quantities." (Italics ours.) (Jurisdictional Statement, p. 46.)

"The former [the central advertising division] enables appellant to spread its advertising cost over more stores and units and to secure its advertising at a lower cost per unit, thereby making possible advertising opportunities unavailable to a single store; as to the latter (central accounting and management department), the volume of business resulting from operation of the company's several stores permits better as well as more costly services of accounting and management to be available to each store, whereas if each were separately operated, services of such quality in all probability would be too expensive to be practicable." (Jurisdictional Statement, p. 47.)

"In the case at bar appellant has not furnished any explanation of why its California business differs so from the average that the formula produced an erroneous result." (Jurisdictional Statement, p. 55.)

All of these are matters wholly outside of the Stipulation of Facts, and amount to mere speculation and conjecture on the part of the court in direct violation of paragraph 12 of the Stipulation of Facts.

In the Petition for Rehearing which was filed in the California Supreme Court, and which is included in the record filed herein, we called the Court's attention to these conjectural matters. As to the first statement above quoted, perhaps the court merely meant that the elimination of sales at any house equal to those at the San Francisco house would not affect the company's aggregate buying power. But even this would be problematical. Suppose that some other of appellant's several houses, say the Chicago house, had total sales of $15,000,000. Then suppose further that $5,000,000 of these sales were eliminated. What the result would be if carried to a normal and logical conclusion is purely conjectural. If such an event were to take place, the Chicago house might not be able

even to operate, thereby eliminating—through cause and effect—the whole of the $15,000,000. So far as anything appearing in the stipulation in this case is concerned such elimination would most certainly affect the company's aggregate buying power. The statement of the California Supreme Court therefore in this light must be considered purely as an abstraction and meaningless.

As a matter of fact, however, we are inclined to doubt if the California court intended such a limited meaning to its statement. The following sentence is that by proceeding in turn from state to state it could be shown that "none of the sales" in any of the states should be credited with the income resulting from the purchasing of goods in large quantities. We would understand the court to mean by this statement that the elimination of the whole of the sales at some one or another of the other houses would have no effect upon the company's aggregate buying power. There is nothing in this record to support such a violent assumption or conjecture. The effect of the elimination or addition of amounts equal to the purchases made for the account of the San Francisco house was the subject matter of paragraph 9 of the Stipulation of Facts. (Jurisdictional Statement, pp. 14-15.) There was no equivalent stipulation as to the effect of the elimination or addition of amounts equal to the purchases made for the account of any of Appellant's other houses. Whatever such effect might be is not the proper subject matter of conjecture in deciding this case.

As to the second statement above quoted, there is nothing whatsoever in the stipulation as to what constitutes the so-called "central advertising division" mentioned in paragraph 4 of the stipulation and the expense of which constituted a part of the common expense. (Jurisdictional Statement, p. 13.) In Appellant's Petition for Rehearing in the court below, to which we have referred, Appellant offered to show by evidence that the

"so-called advertising of the company consists wholly

> in the preparation of catalogs and their distribution to retailers with whom the company does, or seeks to do, business, and that no advertising advantages other than certain economies of preparation exist by reason of the presence of the seven houses."

Likewise there is no such term used any where in the stipulation as "central accounting and management division"—although we can only assume that the court has in mind the statement in paragraph 4 of the stipulation that there are included in the allocated common expenses "executive salaries" and "certain accounting expenses." The court's statement, therefore, as to the economies of what it terms the "costly services of accounting and management" are wholly speculative and conjectural.

As to the last statement above quoted, we have already taken occasion to say that the court below, as does Appellee, seems in this indirect fashion to challenge the correctness of the *stipulated* facts as to the California loss. As has just been stated, the reason for there being a loss in California is of no relevancy as against the controlling factor that a loss did in fact result as shown by the stipulation. In Appellant's petition for rehearing in the court below Appellant as to this point offered to produce evidence as to why the San Francisco house operated at a loss. This portion of the petition for rehearing appears in the record. We point out, however, both as to this point and as to the nature of the so-called "central advertising division" Appellant has the right to produce the evidence itself—if such evidence is to be deemed material—and should not be required to present it to the court in any such summary manner.

Appellee now says that the ultimate conclusion from the facts stipulated as to the results of the Appellant's operations in California would itself be barred if our objection were good, and that therefore Appellant has stipulated itself out of court. The answer to this argument would

seem rather obvious. In the first place, Appellee is incorrect in saying that in such a case the California court would be guilty of a mere error which would not give this Court jurisdiction. When a reviewing court decides a case by indulging in inferences and presumptions and in speculation and conjecture contrary to the agreement and stipulation of the parties upon which the case was tried, which in terms precludes any decision from being made based upon any such inferences and presumptions or speculations or conjectures (Stipulation of Facts, par. 12) and resolves all of such inferences, presumptions, speculations and conjectures adversely to Appellant instead of remanding the case for the taking of further evidence to supply the deficiencies as said paragraph 12 of the Stipulation of Facts contemplated, appellant has in effect been denied an opportunity to be heard upon matters which, at least to the mind of the California court, were material facts. Such a situation is clearly within the principles announced in *Saunders* v. *Shaw*, 244 U. S. 317. Appellant certainly had no reason to anticipate that the California Supreme Court would find it necessary to, and would actually depart, from the stipulation of the parties in deciding this case adversely to appellant—certainly when the California Appellate Court in its opinion and judgment had held the assessment void. Jurisdictional Statement, Exhibit D, pp. 33-41. And this action having been done by the California Supreme Court in its opinion in this case, Appellant's first opportunity of objecting to such procedure was through its petition for rehearing herein. Where there is such a denial of an opportunity to be heard Appellant's constitutional rights have been infringed and the objection can be taken for the first time on the petition for rehearing. *Saunders* v. *Shaw, supra; Ex rel. Missouri Insurance Co.* v. *Gehner*, 281 U. S. 313; *Brinkerhoff-Faris Co.* v. *Hill*, 281 U. S. 673. See also *American Surety Co.* v. *Baldwin*, 287 U. S. 156; *Great Northern Ry. Co.* v. *Sunburst Oil & Refining Co.*, 287 U. S. 358.

The further answer is that Appellant's challenge was not directed to the Court's making the ultimate factual conclusion from the facts which were stipulated, but it was directed to such inferences and presumptions as the court indulged in when it questioned the stipulated facts and questioned whether or not a loss ever occurred and speculated as to the advertising division, and executive salaries and accounting expenses. Finally we point out that even if Appellee were correct and the court below was precluded from making the ultimate conclusion from the stipulated facts that a loss resulted in California, paragraph 12 of the Stipulation would still operate and the case would have to be returned to the trial court for the taking of further proofs as the Stipulation in terms provides.

Appellee, on page 9 of its Motion and Argument, states that the purpose of the Stipulation

> "was to overcome the presumption of official regularity and not to shift the burden of proof from plaintiff to defendant or to remove the burden of proof from both parties."

Nothing in the Stipulation suggests that paragraph 12 had any such limited or restricted meaning or effect. The obvious purpose of a stipulation of facts is to obviate the time and expense of taking evidence as to factual matters which are agreed upon by the parties. It was supposed by both parties that the facts stipulated were sufficient to permit of a decision of this case upon the merits. The purpose of the stipulation was to preclude any decision adverse to either Appellant or Appellee in the possible event that the facts as stipulated were insufficient to permit of a decision being made. This can only be the meaning of paragraph 12 in providing that if

> "this stipulation fails to establish any fact necessary to a decision, the case shall be reopened for the taking of further proofs with respect thereof." (Stipulation of Facts, paragraph 12.)

We do not question the right of the court below to refuse to decide a question of such importance as that involved in the present case if the facts presented to it are not adequate in its view for the purpose. That was what the stipulation was intended to accomplish—and specifically to preserve the right of either party in such an event to offer evidence as to any matters which the Court might deem material and which were not covered by the stipulation. To send the case back for a further hearing pursuant to the agreement embodied in said paragraph 12 of the stipulation is a far cry from speculating upon matters not covered by the stipulation—at least in the Court's mind—and indulging in inferences and conclusions adverse to Appellant. Appellant contends that the stipulated facts are adequate without additions thereto by the Court in the way of inference or presumption to decide the Federal question presented, and that the facts as stipulated require a decision in Appellant's favor if the case is to be decided consistently with the principles announced in the *Rees* case. The decision of the California Supreme Court in these respects is what we are seeking to have this Court review on appeal and, as we believe, as a matter of right—and this wholly without regard to how this Court ultimately decides the question. Otherwise the State Court is made the final arbiter as to rights granted Appellant under the Federal Constitution.

And if in the face of paragraph 12 of the Stipulation the stipulated facts themselves are deemed insufficient to permit of a decision of this case, and if thereupon the case is to be decided adverse to Appellant contrary to such stipulation, Appellant certainly has been denied the requisite opportunity to be heard as to the validity of the tax in question.

We respectfully ask that Appellee's motion to dismiss or affirm be denied.

As we endeavored to point out in our Jurisdictional Statement at page 19, we do not understand that this Court regards the *Rees* case as overruled or shaken in any way by any of its later decisions. As we understand it, in the *North American Cement* case the State accepted the *Rees* case without question, and argued the case upon the ground that it came within the principles of the *Underwood* and *Bass* cases rather than the *Rees* case. If the *Rees* case is not to be adhered to the Court can so state in deciding the case of the present Appellant.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1941.

No. 283

BUTLER BROTHERS, A CORPORATION,
Appellant,

vs.

CHARLES J. McCOLGAN, AS FRANCHISE TAX COMMISSIONER OF THE STATE OF CALIFORNIA,
Appellee.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA.

APPELLANT'S BRIEF.

LELAND K. NEEVES,
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THE SUNTHORP-WARREN PRINTING COMPANY, 310 WEST JACKSON, CHICAGO

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941.

No. 283.

BUTLER BROTHERS, A CORPORATION,

Appellant,

vs.

CHARLES J. McCOLGAN, AS FRANCHISE TAX COMMISSIONER OF THE STATE OF CALIFORNIA,

Appellee.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA.

APPELLANT'S BRIEF.

MAY IT PLEASE THE COURT:

OPINIONS BELOW.

The opinion of the California Supreme Court is reported in 17 Cal. (2), 664, 111 Pac. (2d) 334. It appears in the record beginning at page 24.

The opinion of the California District Court of Appeals is reported in 101 C. A. D. (Calif. App. Dec.) 612, 102 Pac. (2d) 776. It appears in the record beginning at page 16.

There was no opinion in the trial court. The judgment of that court appears in the record at pages 12-13.

JURISDICTION.

The judgment of the court below was entered on March 21, 1941. (R. p. 38.) The petition for rehearing was denied on April 17, 1941. (R. p. 41.)

Application for appeal was made and granted on June 28, 1941.

The transcript of the record was filed in this Court on July 19, 1941. Probable jurisdiction was noted on October 13, 1941.

The jurisdiction of this Court is invoked under section 237 (a) of the Judicial Code as amended. 28 U. S. C. A., section 344 (a). There is here drawn in question the validity of a statute of the State of California on the ground of its being repugnant to the Constitution of the United States. The decision of the California Supreme Court, which is the highest court of the State of California in which a decision in this suit could be had, was in favor of its validity.

Appeal now lies in lieu of a writ of error. Act of January 31, 1928, Chapt. 14, 45 Stat. 54, as amended by Act of April 26, 1928, Chapt. 440, Stat. 466. The case is one in which under legislation in force when the above Act of January 31, 1928 was passed, review could be had in this Court on writ of error.

Where the question is as to the validity of a statutory method of apportionment of net income and as to the validity of the statute so authorizing or requiring such method of apportionment, the review is by way of appeal from the judgment of the state court.

Underwood Typewriter Co. v. *Chamberlain*, 254 U. S. 113.

Bass, Ratcliff & Gretton v. *State Tax Commissioner*, 266 U. S. 271.

Hans Rees' Sons, Incorporated v. *North Carolina*, 283 U. S. 123.

Norfolk & Western Ry. Co. v. *Maxwell*, 297 U. S. 682.

North American Cement Corporation v. *Graves*, 299 U. S. 517.

STATEMENT.

This suit was brought by Appellant in the Superior Court of the State of California in and for the City and County of San Francisco, against the State Treasurer of the State of California to recover a franchise tax amounting to $3,798.43, together with interest thereon amounting to $344.67. The tax was assessed under the provisions of the Bank and Corporation Franchise Tax Act of California. (Statutes 1929, p. 19, as amended.) Section 4, subdivision 3, and section 10 of said Act as in force at all times material to this case are set forth in the margin.[1] Payment of the tax and interest was made under protest.

The tax here in question was assessed with respect to the year 1936, but under the statute was determinable in accordance with Appellant's net income in California for the year 1935.

---

1. "4. *Financial corporation to pay tax.* • • •

(3) *Corporations other than financial doing business in this State to pay tax. Minimum tax.* With the exception of financial corporations, every corporation doing business within the limits of this State and not expressly exempted from taxation by the provisions of the Constitution of this State or by this act, shall annually pay to the State, for the privilege of exercising its corporate franchises within this State, a tax according to or measured by its net income, to be computed, in the manner hereinafter provided, at the rate of four per centum upon the basis of its net income for the next preceding fiscal or calendar year. In any event, each such corporation shall pay annually to the State, for the said privilege, a minimum tax of twenty-five dollars.

• • • • •

"10. *Computation of tax on intrastate business.* If the entire business of the bank or corporation is done within this State, the tax shall be according to or measured by its entire net income; and if the entire business of such bank or corporation is not done within this State, the tax shall be according to or measured by that portion thereof which is derived from business done within this State. The portion of net income derived from business done within this State, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, pay roll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation.

"If the commissioner reallocates net income upon his examination of any return, he shall, upon the written request of the taxpayer, disclose to him the basis upon which his reallocation has been made."

Appellant filed its return for the year 1936, from which return it appeared that Appellant had a loss of $82,851 for the year 1935. Accordingly, Appellant paid the minimum tax of $25 upon the filing of its return.

On January 25, 1937 the Franchise Tax Commissioner notified Appellant of the proposed additional assessment of $3,798.43—which is the tax here involved. Thereupon Appellant protested such assessment. (R. p. 3.) The protest asserted the invalidity of the assessment under the rule of *Hans Rees' Sons, Incorporated* v. *North Carolina*, 283 U. S. 123. (R. p. 4.) On August 5, 1937, Appellant was advised that the additional assessment had been confirmed, and on September 8th the additional tax was assessed with interest from March 15, 1936. On September 16, 1937 the additional assessment, together with the interest thereon amounting to $344.67, was paid—under protest. (R. p. 4.) Among other things it was stated in the protest that the tax

> "is a tax upon business and transactions conducted without the State of California, is without the power of jurisdiction of the State of California, will deprive Butler Brothers of property without due process of law, will deprive Butler Brothers of the equal protection of the law, and is in violation of its rights under the Constitution of the United States and the Constitution of the State of California.
>
> "The Bank and Corporation Franchise Tax Act, if construed as authorizing the assessment of the taxes here protested, is in violation of the Constitution of the United States and of the Constitution of the State of California."

On October 18, 1937, this suit was filed. (R. p. 1.) The complaint asserted the invalidity of the entire assessment. (R. p. 2.) Copies of the two protests were attached to the complaint as exhibits A and B thereto. (R. pp. 3, 4.)

In his answer to the complaint the State Treasurer denied the allegations of the complaint as to the invalidity

of the assessment, and further denied the allegations contained in said Exhibit B to the complaint. (R. p. 7.)

The case was tried upon a stipulation of facts.

Paragraphs 10 and 11 of the Stipulation provided as follows (R. p. 11):

> "10. It is claimed by defendant that by reason of the facts hereinabove set forth the operations of the Company are unitary in character and that the formula for allocation of income used by the Franchise Commissioner was lawful and proper and that the Company is not entitled, for the purpose of determining tax payable under the Bank and Corporation Franchise Tax Act, to use separate accounting of its San Francisco house to determine its net income in the State of California."
>
> "11. It is claimed by the Company that its operations are not unitary in character; that its net income reasonably attributable to the business done within the State of California is the income derived from its San Francisco house alone which resulted in a loss in the year 1935; that the method of allocation used by the Commissioner is not in accordance with the provisions of the Bank and Corporation Franchise Tax Act, and that if said Act is construed as authorizing such method of allocation and assessment, said Act is in violation of the due process clause of the Fourteenth Amendment to the Constitution of the United States."

The trial court sustained the validity of the tax and entered judgment against Appellant, adopting in that connection the stipulation of facts as its own findings of fact, and simply holding that the additional assessment was "duly and regularly made" pursuant to the statute. (R. p. 13.)

Appellant thereupon appealed to the Supreme Court of the State of California. Subsequently Charles J. McColgan as Franchise Tax Commissioner of the State of California, Appellee herein, was substituted in place of

Charles G. Johnson as Treasurer, who was the original defendant. (R. pp. 15-16.)

Thereafter the California Supreme Court transferred the case to the District Court of Appeal for the Third Appellate District for hearing. That Court held the assessment void, and accordingly reversed the judgment of the trial court with directions to the trial court to enter judgment for Appellant. (R. p. 24.)

Thereupon, upon defendant's petition, the California Supreme Court directed that the case be retransferred to it for hearing.

Upon hearing in that court the assessment was held valid. The California Supreme Court held that Appellant's business was "unitary" in character and that the use of an allocation formula was made mandatory by the statute. The statute as thus construed and applied was also held valid and in no way repugnant to the Federal Constitution. The judgment of the trial court was accordingly affirmed. (R. p. 38.)

Appellant's petition for rehearing was, as stated, denied on April 17, 1941. (R. p. 41.) This appeal followed.

The Facts.

As stated, the case was tried upon a stipulation of facts, which stipulation was adopted by the trial court as its findings of fact. (R. p. 13.) The facts so stipulated are not lengthy, and are as follows (R. pp. 8-13):

> "1. Butler Brothers, plaintiff herein (hereinafter called the Company), is a corporation organized under the laws of Illinois and is qualified to conduct business in California. Its corporate principal place of business is in Chicago, Illinois. The Company is engaged in the wholesale dry goods and general merchandise business, purchasing from manufacturers and others, and selling such commodities to retailers only.

It maintains and operates wholesale distributing houses at Chicago, Illinois, Minneapolis, Minnesota, St. Louis, Missouri, Jersey City, New Jersey, Baltimore, Maryland, Dallas, Texas, and San Francisco, California. The San Francisco house was opened by the Company in 1928, being the last established of all the Company's houses, except that the one at Baltimore was acquired as a going concern in 1930.

"2. Stocks of goods are maintained at each of the Company's houses hereinabove mentioned, from which sales in the respective territories served by each house are made. Each house serves a separate trade territory, having its own sales force, and all sales made by the Company in the State of California are made from the San Francisco house. Each house handles its own sales and all solicitation, credit and collection arrangements in connection therewith. Books of account are kept at each house, wherein are entered the sales made thereat, the amounts paid for goods sold therefrom, transportation charges and other operating expenses, including the allocation of certain common expenses referred to in paragraph 4 hereof. It is agreed that all receipts from sales made in California have been credited to the San Francisco house.

"3. The Company maintains a central buying division through which goods for resale are ordered, but such goods are shipped by the manufacturers to the houses for which ordered, where the cost thereof and transportation charges thereon are entered on the books of the house. No charges are made against any house for the benefit of the Company or any other house by reason of such centralized purchasing, but the actual cost of operating the centralized buying division is allocated to the houses, as stated in paragraph 4 hereof. The greater part of other operating expenses incurred by the Company are directly and exclusively incurred at the respective houses, including such items as labor, rentals and similar expenses.

"4. There are certain items of expense which are incurred and paid by the Company for the benefit of all houses, the costs of which are allocated to the re-

spective houses. No question exists as to the accuracy of the amounts of such expense or to the method of allocation employed, which is in accordance with recognized accounting practices. For the year 1935 the amount of such allocated expense charged to the San Francisco house was $100,091. For the purposes of this case, and without prejudice to the claims of either party in any subsequent year, it is agreed that approximately 75% of the $100,091 overhead expense so allocated would have been incurred even though the San Francisco house was not operated, and that the accuracy and propriety of the basis of allocation of such common expenses for the year 1935 are admitted. Included in such expenses are executive salaries, certain accounting expenses, the cost of operating a central buying division, and a central advertising division. Except for such common expenses, each house is operated independently of each other house.

"5. The Company computed its income from the operation of the San Francisco house by deducting from the gross receipts from sales of merchandise in California, determined as indicated in paragraph 2 above, the costs of such merchandise, determined as indicated in paragraph 3 above, the direct expenses of the San Francisco house referred to in paragraph 3; and the indirect expense allocated to the San Francisco house in the manner described in paragraph 4 above. According to this computation, the San Francisco house operated at a loss of $82,851 during the year 1935.

"6. The Company filed with the Franchise Tax Commissioner a report in the prescribed form, wherein it was reported that the San Francisco house was operated at said loss, and, within the time provided by law, paid the minimum tax of $25 for the year 1936. An additional assessment was made by the Franchise Tax Commissioner and paid by the Company as alleged in the complaint.

"7. In the year 1935 the operations of all houses of the Company produced a profit of $1,149,677. The

additional tax assessed by the Franchise Tax Commissioner was predicated on the allocation to California of 8.1372% of the total income of the Company derived from all sources, such percentage having been determined by mathematical average of the percentages which (a) value of real and tangible personal property, (b) wages, salaries, commissions and other compensation of employees, and (c) gross sales, less returns and allowances, attributable to the San Francisco house bore to the corresponding items of all houses of the Company. It is also agreed that the Franchise Tax Commissioner, in imposing the additional assessment upon the Company, did not give consideration to any other factor or method of allocation. No question exists as to the accuracy of the Commission's calculation, nor respecting the use of the above formulas, if, by reason of the facts stipulated herein, a formula for allocation to California of a portion of the Company's income from all sources is proper. This stipulation is made without prejudice as to any other year than that on which the tax here involved is predicated.

"8. In the year 1935 the total sales made by the Company at all houses amounted to $66,326,000, of which $5,206,000 were made from the San Francisco house. The purchases made for the account of the San Francisco house were substantially in the same proportion to total purchases. All purchases made by the Company for sale at its various houses are made through a central buying division. By reason of the volume of purchases made by the Company more favorable prices are obtained than would be obtainable in respect of purchases for the account of any individual house operated by the Company.

"9. The addition of purchases in an amount equal to the purchases made for the account of the San Francisco house results in no more favorable prices than could be obtainable in respect of purchases in an amount equal to the purchases which would be made by the Company for its other houses if the San Francisco house were not in existence, and a reduction

in the volume of purchases in an amount equal to the purchases made for the San Francisco house would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the Company. The stipulation in this paragraph shall not be deemed an admission by defendant that plaintiff is entitled to segregate the income of its San Francisco house from that of other houses for purposes of computing franchise tax."

The provisions of Paragraphs 10 and 11 of the Stipulation have been heretofore stated. *Supra*, p. 5.

Paragraph 13 of the Stipulation (R. p. 12) provided as follows:

"13. The stipulations of fact herein contained are without prejudice to the claim of plaintiff that its earnings in California are solely those derived from operation of its San Francisco house, and that it is taxable in California only in respect of such earnings, without regard to earnings from its operations in other states and without prejudice to the claim of defendant that plaintiff's operations in California are of such character as to be incapable of segregation from its other operations, and that plaintiff may be taxed on an allocation of its entire net income in the manner done by the defendant."

Paragraph 12 of the Stipulation (R. p. 11) provided as follows:

"12. It is agreed that the foregoing facts, in addition to those alleged in the complaint and admitted by the answer, were submitted to and considered by the Franchise Tax Commissioner, and that the assessment of additional tax made by him was predicated entirely upon the theory that as a matter of law the business done by the Company as hereinbefore set forth is a part of a unitary business warranting the application of the method of allocation of the Company's total net income hereinabove described. It is agreed that no other fact or circumstance was con-

sidered or used by the Commissioner in making such assessment and that the Court, in determining this case, shall be bound by no inference or presumption in respect of any matter of fact not herein set forth, and if, despite this stipulation, the Court deems that it is bound by any inference or presumption respecting the assessment made by the Commissioner, or that this stipulation fails to establish any fact necessary to a decision, the case shall be re-opened for the taking of further proofs in respect thereof."

Points Relied On and Specification of Such of the Assigned Errors as Are Intended To Be Urged.

"That the Supreme Court of the State of California erred in rendering its said decision, affirming the judgment of the Superior Court of the State of California in and for the City and County of San Francisco, the court of first instance in said cause, in each of the respects hereinafter stated:

"1. In holding that the California Bank and Corporation Franchise Tax Act, California Statutes of 1929, page 19, as amended, did not deprive Petitioner of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

"2. In holding that said Act did not impose a tax on income of Petitioner earned and derived from sources wholly outside of the State of California, thus depriving Petitioner of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

"3. In holding that said Act did not deprive Petitioner of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States, although said Act as construed by said Court levied a tax upon a percentage of Petitioner's net income allocated to the State of California by an arbitrary allocation formula (based upon a comparison of Petitioner's property, payroll and sales within California as compared to Petitioner's

total payroll, property and sales), in spite of the fact that Petitioner's operations in the State of California were conducted at a loss of $82,851 and Petitioner in fact earned no net income from its operations within the State of California and derived no net income from sources within the State of California.

"4. In holding that although in fact Petitioner's operations within the State of California resulted in a loss of $82,851, it was nevertheless subject to a tax on an assumed net income of more than $90,000 by application of the formula prescribed by said Bank and Corporation Franchise Tax Act as amended, and in holding that said Act in imposing such tax did not deprive appellant of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

"5. In holding that Petitioner's business, although it consists only of buying and selling merchandise, is a 'unitary' business; in holding that in the case of a unitary business the Bank and Corporation Franchise Tax Act imposes a tax based on a formula allocation of income regardless of an actual loss incurred on business done in California, and in holding that said Act in so imposing such tax does not deprive appellant of its property without due process of law, in violation of the Fourteenth Amendment to the Constitution of the United States.

"6. In deciding this case by indulging in inferences and presumptions contrary to the provisions of paragraph 12 of the stipulation of facts upon which this case was tried." (Assignment of Errors, R. pp. 41-43; Statement of Points to be Relied Upon, R. pp. 46-48.)

SUMMARY OF ARGUMENT.

The Bank and Corporation Franchise Tax Act of California provides for a tax in the case of a foreign corporation "for the privilege of exercising its corporate franchises within this State according to or measured by its net income to be computed" etc., and (sec. 10) that if the entire business of the corporation is not done within California the tax shall be according to or measured by that portion thereof "which is derived from business done within" California, and finally that such income is to be determined either by an allocation based upon sales, purchases, expenses of manufacture, payroll, value and situs of the tangible property "or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the state the portion of net income reasonably attributable to the business done within this state and to avoid subjecting the taxpayer to double taxation." Appellant is engaged in the wholesale merchandise business and operates seven branch houses, one of them situate in San Francisco. Appellant purchases its merchandise from manufacturers throughout the United States, which merchandise is shipped from the various factories and mills directly to the respective branch houses. Each house sells throughout its own trade territory, out of stocks of merchandise maintained at such house. Each house has its own sales force and handles its own sales solicitation, credit, and collection arrangements. Books of account are kept at each house wherein are entered the sales made, the amounts paid, transportation charges, and other operating expenses including the allocation of certain common expenses. All receipts from sales made at San Francisco are credited to that house, including receipts from sales in other states comprised within the San Francisco house's

trade territory. Merchandise is purchased by a central buying division, although the merchandise itself is shipped from the various factories and mills where produced directly to the various houses. Appellant's sales are made to retailers for purposes of resale. Each house is charged only with the actual cost of the merchandise which it sells plus transportation charges from the factory or mill to such house. No charge is made against any house for the benefit of the company or any other house by reason of such centralized purchasing. The greater part of other operating expenses incurred by the company are directly and exclusively incurred at the respecting houses, including such items as labor, rental, and the like.

There are certain items of expense which are incurred and paid by the company for the benefit of all houses, the costs of which are allocated to the respective houses. The parties have agreed that no question exists as to the accuracy of the amounts of such expense or to the method of allocation employed which is in accordance with recognized accounting practices. In 1935 the amount of such allocated expenses to the San Francisco house was $100,091. For the purposes of this case, it is agreed that approximately 75 per cent of that amount would have been incurred even though the San Francisco house was not operating. Included in these common expenses are "executive salaries, certain accounting expenses, the cost of operating a central buying division, and a central advertising division." (Stip. Par. 4, R. p. 9.) It is expressly agreed by the parties that "except for such common expenses, each house is operated independently of each other house." (Stip. Par. 4, R. p. 9.)

Appellant computed its income from the operations of the San Francisco house by deducting from the gross receipts of sales of merchandise made at that house, first, the cost of such merchandise, second, the direct expenses of the San Francisco house above referred to, and, third, the al-

located expense. According to this computation the San Francisco house operated at a loss of $82,851 during the year 1935. Appellant filed its return for the calendar year 1936 and (its operations for the preceding year, which determined the amount of the tax for the ensuing year, showing a loss) paid the minimum tax of $25.00.

In 1935 the operations of Appellant's houses as a whole produced a profit of $1,149,677 after taking into consideration the loss at San Francisco of $82,851. Appellee assessed an additional franchise tax based upon an allocation of a percentage of Appellant's above total net income, such percentage—8.1372 per cent—being determined by averaging the percentages of the (1) value of real and tangible personal property in the state, (2) wages, salaries, commissions and other compensation of employes, and (3) gross sales attributable to the San Francisco house as compared to the corresponding items of all Appellant's houses. The parties further agreed that in assessing the additional tax Appellee gave no consideration to any other factor or method of allocation, and that for the purposes of this case no question exists as to the accuracy of Appellee's calculation, nor respecting the use of said formula if, under the facts of the case as stipulated, an allocation formula applied to Appellant's total net income is proper. (R. p. 10.)

Appellant's total sales for 1935 were $66,326,000. The sales of the San Francisco house were $5,206,000. The purchases of merchandise made for the San Francisco house were substantially in the same proportion of total purchases as the San Francisco sales were to the total sales. It was further agreed that by reason of the volume of purchases made by Appellant more favorable prices were obtained than would be obtainable with respect to purchases for the account of *any individual house* operated by Appellant.

The parties further agreed that the "addition of pur-

chases in an amount equal to the purchases made for the account of the San Francisco house results in no more favorable prices than could be obtainable in respect of purchases in an amount equal to the purchases which would be made by Appellant for its other houses if the San Francisco house were not in existence, and a reduction in the volume of purchases in an amount equal to the purchases made for the San Francisco house would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the company." (Stip. of Facts, Par. 9; R. p. 10.)

The parties further stipulated that the assessment here involved "was predicated entirely upon the theory that as a matter of law the business done by the company as hereinbefore set forth is a part of a unitary business warranting the application of the method of allocation of the company's total net income hereinabove described." (Stip. of Facts, Par. 12; R. p. 11.) Said paragraph 12 of the stipulation further provides that it "is agreed that no other fact or circumstance was considered or used by the Commissioner in making such assessment and that the Court, in determining this case, shall be bound by no inference or presumption in respect of any matter of fact not herein set forth, and if, despite this stipulation, the Court deems that it is bound by any inference or presumption respecting the assessment made by the Commissioner, or that this stipulation fails to establish any fact necessary to a decision, the case shall be reopened for the taking of further proofs in respect thereof."

I.

THE TAX HERE INVOLVED IS VOID. THE CALIFORNIA STATUTE AS CONSTRUED AND APPLIED BY THE CALIFORNIA SUPREME COURT IS LIKEWISE VOID. THE CASE OF HANS REES' SONS, INCORPORATED v. NORTH CAROLINA, 283 U. S. 123 IS CONTROLLING.

Asserting reliance upon *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113; *Bass, Ratcliff & Gretton* v. *State Tax Commission*, 266 U. S. 271, and *North American Cement Corporation* v. *Graves*, 299 U. S. 123, the court below considered Appellant's business to be "unitary," held the statutory formula method of allocating income to California to be mandatory and the statute and the consequent tax to be valid.

The court further considered that the decision of this court in *Hans Rees' Sons, Incorporated* v. *North Carolina*, 283 U. S. 123, did not control. Apparently the court below thought that because the merchandise sold by the San Francisco house was centrally purchased along with the merchandise sold by Appellant's other houses, the San Francisco house operations were so integral a part of Appellant's business as a whole that the income of that house—the income from Appellant's California business—could not be segregated or separately determined.

The court below argued that because, according to the stipulated facts, Appellant was able to buy at lower prices because of its volume of purchases—something which we would think would be more or less self evident—Appellant's San Francisco house and business were therefore completely interdependent upon Appellant's other houses and upon its business as a whole. Having thus viewed the operations of the San Francisco house and Appellant's business as a whole, the court below thought Appellant's business to be "unitary."

In the above connection the court below has put aside

the explicit stipulation of the parties, that the addition or subtraction of purchases equal to the amount purchased for the account of the San Francisco house would have absolutely no effect upon Appellant's aggregate purchasing power. (Stipulation of Facts, Par. 9, R. p. 10.) There was no such stipulation in that regard with respect to any of Appellant's other houses. And the court below thus challenges the correctness of the facts which the parties to this suit have themselves agreed upon for the express purposes of this suit.

The court below also stated that Appellant's San Francisco house should be "credited with the profits resulting from the purchasing power which such sales in the aggregate produce." (R. p. 29.) In making this statement the court loses sight of the fact that the San Francisco house was in fact credited with its full proportionate share of the profits resulting from Appellant's aggregate purchasing power when that house was charged only with the actual cost of the merchandise which it sold. We see no other conceivable way in which the San Francisco house could be given the full credit of its proportionate share of the profit resulting from Appellant's aggregate purchasing power. Only if it appeared that the San Francisco house was charged with more than the cost of the merchandise—like the Wisconsin business involved in *Standard Oil Co. v. Wisconsin*, 197 Wis. 630, 223 N. W. 85—would the view of the court below have any semblance of merit.

Contrary to what seems to be the view of the court below and of Appellee, the *Rees* case is not to be considered as overruled by *North American Cement Corporation v. Graves*, 299 U. S. 317. The last named case was simply a decision of the same kind as in the *Underwood Typewriter* case and in the *Bass* case, it being held (in the *North American Cement* case) that the New York statute is "valid upon its face and it has not been shown to have been so ap-

plied as to violate" the corporation's constitutional rights —citing the *Bass* case.

The principle of the *Rees* case is a principle of long standing. Such principle had been repeatedly applied by this court in earlier decisions where taxes based upon statutory formulae were invalid because of the factual showing made that the application of the formula produced unreasonable and arbitrary results.

There is no real relevancy between the factors entering into the statutory percentage formula applicable to the San Francisco house and the same factors as applied to Appellant's business as a whole. It is difficult, if not impossible, to conceive how, in view of the manner in which Appellant's several houses are operated, the Appellant's merchandise or other property, including real estate, owned by the company in other states or the amount of its payroll, etc., in other states, or even its gross sales in other states, have or could have any direct bearing upon the results of the operation of the San Francisco house. All of that property; and all of such wages and salaries, and such sales, could be more or less in amount in dollars in other states without materially affecting the results of the San Francisco house whatsoever.

II.

THE FACT THAT A BUSINESS IS "UNITARY" IS NOT CONTROLLING IN DETERMINING THE LEGALITY OF A STATUTORY FORMULA METHOD OF APPORTIONMENT.

Even if Appellant's business were unitary the tax is still void. This was expressly held in *Hans Rees' Sons, Incorporated* v. *North Carolina*, 283 U. S. 123, where this Court assumed the business of the company there involved to be unitary (a manufacturing business), but still held the formula method of allocation and the resulting tax invalid

on the ground that the evidence showed that the result of the application of the statutory formula was unreasonable and arbitrary. In that connection the evidence tended to show that only 17 per cent of the company's business was properly attributable to North Carolina, whereas the statutory formula attributed about 80 per cent to that state. In the instant case, according to the actual figures, Appellant incurred a loss of $82,851 in California. The application of the statutory allocation formula resulted in attributing to California income amounting to $93,551.50—thereby converting a loss *in fact* of $82,851 into an alleged profit of $93,551.50, a difference of $175,000. To attribute $175,000 of additional income to California in order to produce a tax means either that that much income has been appropriated from other states—thereby subjecting Appellant to double taxation with respect to such income—or else it means that Appellant's total net income is $175,000 more in the aggregate than what the parties have agreed it to be. In either view the operation and application of the statutory allocation formula is unreasonable, arbitrary and confiscatory. And the resulting tax is invalid within the principle of the *Rees* case.

The California court's conception of the rule is clearly erroneous when it says (R. p. 27) that only where the business within the taxing state is truly separate and distinct from its business without the state so that segregation of income may be made clearly and accurately, that the separate accounting method may properly be used. We submit that the term "separate accounting" is of no special significance. The rule of this court is that if the allocation formula results unreasonably or arbitrarily it will not be sustained even where the company's business is unitary. This rule applies even in the case of interstate carriers where it would be a rare occasion, if it ever occurred, where the rail mileage within the taxing state is "truly separate and distinct" from its mileage without the state.

The rule, concisely stated, is that if the income from the business within the state can be reasonably and accurately determined upon its own footing, and if it then appears that the application of the statutory formula attributes income to the taxing state grossly disproportionate to the income separately determined, the formula will not be sustained, and any tax resulting from the application of the formula will be invalid. Indeed the rule is even broader. Where the income within the taxing state is capable of separate determination with reasonable accuracy, there is no room for any apportionment formula.

III.

THE FACT THAT THE TAX IS AN EXCISE TAX IS IMMATERIAL.

This court, in the *Underwood Typewriter* case, said that in considering the question as to the validity of the tax all question is laid aside as to whether the tax is an excise, purporting to be measured by income, or is a direct tax upon that income, and that the decision in any particular case will not be made to depend upon mere definitions. Appellees contention in this regard necessarily assumes that the *Rees* case involved an income tax and not an excise tax. Such is not the case, as the statute imposing the tax in the *Rees* case was characterized by the North Carolina court as substantially identical with the Connecticut statute involved in the *Underwood Typewriter* case, which statute in turn was held by the Connecticut court to lay an excise tax upon the privilege of doing, or the doing of, business in Connecticut. The California statute also lays an excise tax with the result that the *Rees* case is wholly in point.

IV.

APPELLANT'S BUSINESS IS NOT A UNITARY BUSINESS.

Whatever may be said of manufacturing businesses like that in the *Underwood* and *Bass* cases, Appellant's business is not a unitary business. It operates a collection of seven wholesale branch houses, each of which is conducted to all intents and purposes as a separate establishment. The fact of common ownership necessitates some allocation of overhead and other common expense. But this fact does not of itself make the business a unitary business. For a consideration of what constitutes a unitary business see *Maxwell v. Kent-Coffey Mfg. Co.*, 168 S. E. 397; *State* v. *Lion Oil Refining Co.*, 284 S. W. 33; *Utah-Idaho Sugar Co.* v. *Salt Lake County*, 210 Pac. 106; *Standard Oil Co.* v. *Wisconsin Tax Commission*, 197 Wis. 630, 223 N. W. 85; *Standard Oil Co.* v. *Thoresen*, C. C. A. 8, 29 Fed. (2d) 708; *Fisher* v. *Standard Oil Co.*, C. C. A. 8, 12 Fed. (2d) 444; *Standard Oil Co.* v. *Howe*, 257 Fed. 481; *J. G. McCrory Co.* v. *Commissioner*, 280 Mass. 273, 182 N. E. 481; *Mexican Petroleum Corporation of Georgia* v. *Head*, 13 S. E. (2d) 887. These cases all understood the principle of the *Rees* case (distinguishing in that connection cases like the *Underwood Typewriter* and *Bass* cases). Where the business within the taxing state is capable of reasonable segregation and separation in determining income there is no proper basis for applying a statutory formula.

V.

APPELLANT HAS NOT ACCEPTED AN ALLOCATION FORMULA IN PART AND ATTACKED IT IN PART.

This contention of Appellee is based upon *Norfolk & Western Ry. Co.* v. *Maxwell*, 297 U. S. 682. That case presents nothing of the situation involved in the instant case. There the carrier was attempting to allocate to North

Carolina income upon a formula allocation of its gross income, but to determine its North Carolina expenses by assigning specific expenses to the operation of the lines in that state. The state had offered evidence showing that the application of the formula resulted in a larger underestimate of revenue than a possible underestimate of expenses. The record as a whole left it uncertain as to whether the application of the formula to both revenue and expenses injured the company. There is no such situation presented in the case at bar.

ARGUMENT.

I.

THE TAX HERE INVOLVED IS VOID. THE CALIFORNIA STATUTE AS CONSTRUED AND APPLIED BY THE CALIFORNIA SUPREME COURT, IS LIKEWISE VOID. THE CASE OF HANS REES' SONS, INCORPORATED v. NORTH CAROLINA, 283 U. S. 123, IS CONTROLLING.

The tax here involved was assessed under the Bank and Corporation Franchise Tax Act of California (Statutes 1929, p. 19, as amended). Section 4, subdivision 3 of the Act (see *supra*, p. 3) requires payment of a tax "for the privilege of exercising its corporate franchises within this state according to or measured by its net income to be computed," etc.

Section 10 of the Act (see *supra*, p. 3) provides that if the entire business of the corporation is not done within California "the tax shall be according to or measured by that portion thereof which is derived from business done within" California.

Section 10 does not provide that the "business done within this state" *must* be determined by an allocation based upon sales, purchases, etc., but that the "business done" shall be determined *either* by such an allocation or

> "by such other method of allocation as is fairly calculated to assign to the state the portion of net income reasonably attributable to the business done within this state and to avoid subjecting the taxpayer to double taxation."

Said section 4, subdivision 3, and said section 10, together with other pertinent provisions of the Act, are set forth in the appendix hereto.

We would suppose that the clear intent of section 10 is to tax only that income which is derived from business done within the State of California, and that if that net income is clearly ascertainable by some method other than by mere formula allocation—which is more or less arbitrary at best—such method would be accepted as determinative of such net income. The court below in its opinion in this case seems to have thought otherwise inasmuch as it now holds that if the taxpayer's business is "unitary" the formula method of allocation is mandatory even though the taxpayer's actual net income from business done in California is otherwise clearly and reasonably determinable, and even though one result of the formula method of allocation is to subject the taxpayer to tax upon the same income both in California and elsewhere.

We submit that the decision below cannot be sustained consistently with the decision of this Court in *Hans Rees' Sons, Incorporated* v. *North Carolina*, 283 U. S. 123. In that case it appeared that the corporation there involved operated a manufacturing establishment in North Carolina. It bought hides, manufactured them into merchandise at its said factory, and sold the manufactured merchandise in numerous other states. The North Carolina statute imposed a tax upon the net income of the company in accordance with a formula based upon the valuation of the real estate and tangible property of the taxpayer within the State as compared to the valuation of the taxpayer's total real estate and tangible property in all states. This formula resulted in attributing to North Carolina approximately 80 per cent of the company's total net income.

Evidence was offered by taxpayer in the trial court which was summarized by the state court as tending to show that for the years 1923 to 1926, both inclusive, the average income of the company having its source in the

manufacturing and tanning operations of the company was 17 per cent. The question was as to whether the tax so resulting from the statutory formula method of apportionment was valid. The state court, relying upon *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113, and *Bass, Ratcliff & Gretton* v. *State Tax Commissioner*, 266 U. S. 271, held the evidence immaterial and sustained the tax. This Court reversed, saying (283 U. S., at p. 132):

> "Evidence which was found to be lacking in the *Underwood* and *Bass* cases is present here. These decisions are not authority for the conclusion that where a corporation manufactures in one State and sells in another, the net profits of the entire transaction, as a unitary enterprise, may be attributed, regardless of evidence, to either State. • • •
>
> "Undoubtedly, the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business, and all the factors in that enterprise are essential to the realization of profits. The difficulty of making an exact apportionment is apparent and hence, when the State has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases. But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one State regardless of the extent to which it may be derived from the conduct of the enterprise in another State. • • • And the principle that was recognized in *National Leather Co.* v. *Massachusetts*, *supra*, was that a tax could lawfully be imposed upon a foreign corporation with respect to 'the proportionate part of its total net income which is attributable to the business carried on within the State.' When, as in this case, there are different taxing jurisdictions, each competent to lay a tax with

respect to what lies within, and is done within, its own borders, and the question is necessarily one of apportionment, evidence may always be received which tends to show that a State has applied a method, which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction."

In the instant case the fact was clearly established by the stipulation of facts that Appellant had incurred a *loss* of $82,851 from its operations in California in 1935, whereas the statutory formula allocated to that state a net income of $93,551.50. In other words, by the mere application of a formula a loss in fact of $82,851 was converted into a taxable profit of $93,551.50. So far as California is concerned, a net income of $175,000 has been created out of nothing. Either that, or $175,000 of income has been appropriated from other states.

Appellee, as we understand it, insists that the instant case is ruled by the *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113, *Bass, Ratcliff & Gretton* v. *State Tax Commissioner*, 266 U. S. 271, and *North American Cement Corporation* v. *Graves*, 299 U. S. 517, cases.[1] In view of Appellee's insistence in this regard we deem it necessary to discuss those cases at some length.

In *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113 (in the State court—94 Conn. 47, 108 Atl. 154), the Underwood Typewriter Company—a Delaware corporation—was engaged in the manufacture, sale and repair of typewriters. Its only manufacturing plant was at Hartford, Connecticut. The company also sold and rented adding machines made in Connecticut by other manufacturers, rented slot machines made by it in Connecticut, and sold desks and other typewriting supplies not manufactured in

1. Appellee also insists that Appellant seeks to use a separate accounting method in part and an allocation method in part, contrary *Norfolk & Western Ry. Co.* v. *North Carolina*, 297 U. S. 682. Appellee's contention in this regard will be discussed in a later portion of this brief.

the state at all. The company's net income as reported for Federal income tax purposes was $1,336,586.13.

The Connecticut statute in terms imposed a tax upon the net income of the corporation. The statute itself was uncertain as to whether as a matter of construction it was intended as imposing a tax in the nature of an excise tax or a tax in the nature of a property tax, or a tax in the nature of a direct tax on income. Of the net income on which the company paid its Federal income taxes, the Tax Commissioner apportioned $629,658.50 to Connecticut as constituting that part of the income properly allocable to that state—based upon the statutory formula. This resulted in allocating 47 per cent of the company's entire net income to the State of Connecticut. The State court stated in its opinion that the company was contending that the tax was levied upon net income resulting from business done and sales made outside of the State of Connecticut, and that that contention erroneously assumed that the tax was an income tax as such and not a privilege tax imposed upon the privilege of carrying on a manufacturing business in the state. Accordingly the court stated that the real question was whether such a privilege tax based upon 47 per cent of the plaintiff's entire net income was a tax upon its business done, or its property located, outside of the state. In this view the statute and the resulting tax was sustained. The court then said that the argument against the constitutionality of the statutory apportionment must go to the point of showing successfully that 47 per cent of the company's net income could not reasonably be attributed to its manufacturing and warehousing and shipping operations in Connecticut. In that view the court went on to say that the burden was upon the company to show the unreasonableness of the allocation and that upon the record before the court the company had made no attempt to shoulder such a burden. The court said that as the record before it

stood it was asked to take judicial notice of the fact that 47 per cent of the net income of the company could not reasonably be attributed to the company's operations in Connecticut, and

> "to declare the statute unconstitutional upon the bare assertion that the statutory method of apportionment, as applied to the company's income, taxes property and business without the state, although 53 per cent of the plaintiff's income is exempted by the apportionment."

This Court (254 U. S. 113) said (p. 118):

> "The Underwood Typewriter Company is engaged in the business of manufacturing typewriters and kindred articles; in selling its product and also certain accessories and supplies which it purchases; and in repairing and renting such machines. Its main office is in New York City. All its manufacturing is done in Connecticut. It has branch offices in other States for the sale, lease and repair of machines and the sale of supplies; and it has one such branch office in Connecticut. All articles made by it—and some which it purchases—are stored in Connecticut until shipped direct to the branch offices, purchasers or lessees."

Then specifically as to the contention that the tax was upon business not within the state it was said (p. 120):

> "It is contended that the tax violates the Fourteenth Amendment because, directly or indirectly, it is imposed on income arising from business conducted beyond the boundaries of the State. In considering this objection we may lay on one side the question whether this is an excise tax purporting to be measured by the income accruing from business within the State or a direct tax upon that income; for the 'argument, upon analysis resolves itself into a mere question of definitions, and has no legitimate bearing upon any question raised under the Federal Constitution.' *Shaffer* v. *Carter*, 252 U. S. 37, 55. In support of its objection that business outside the State is taxed plaintiff rests solely upon the showing that of its net profits $1,293,-

643.95 was received in other States and $42,942.18 in Connecticut, while under the method of apportionment of net income required by the statute 47 per cent of its net income is attributable to operations in Connecticut. But this showing wholly fails to sustain the objection. The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States. In this it was typical of a large part of the manufacturing business conducted in the State. The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a method of apportionment which, for all that appears in this record, reached, and was meant to reach, only the profits earned within the State. 'The plaintiff's argument on this branch of the case,' as stated by the Supreme Court of Errors, 'carries the burden of showing that 47 per cent. of its net income is not reasonably attributable, for purposes of taxation, to the manufacture of products from the sale of which 80 per cent. of its gross earnings was derived after paying manufacturing costs.' The corporation has not even attempted to show this; and for aught that appears the percentage of net profits earned in Connecticut may have been much larger than 47 per cent. There is, consequently, nothing in this record to show that the method of apportionment adopted by the State was inherently arbitrary, or that its application to this corporation produced an unreasonable result."

In *Bass, Ratcliff & Gretton* v. *State Tax Commissioner*, 266 U. S. 271, the New York statute was involved. That statute clearly levied an excise tax upon the privilege of doing business in the State of New York. The corporation there involved was an English company engaged in brewing and selling Bass' ale. All of its brewing was done and a large part of its sales were made in England, although a portion of its product was imported into the United States

and sold through branch offices located in New York City and Chicago. In determining the amount of income allocable to the State of New York a formula was followed which was authorized by the statute (266 U. S. 279). This Court sustained the tax on the authority of the *Underwood* case, saying in that connection (p. 282):

> "So in the present case we are of opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places—the process of manufacturing resulting in no profits until it ends in sales—the State was justified in attributing to New York a just proportion of the profits earned by the Company from such unitary business. In *Wallace* v. *Hines*, 253 U. S. 66, 69, it was recognized that a State, in imposing an excise tax upon foreign corporations in respect to doing business within the State, may look to the property of such corporations beyond its borders to 'get the true value of the things within it, when they are part of an organic system of wide extent,' giving the local property a value above that which it would otherwise possess, and may therefore take into account property situated elsewhere when it 'can be seen in some plain and fairly intelligible way that it adds to the value of the property and the rights exercised in the State.' This is directly applicable to the carrying on of a unitary business of manufacture and sale partly within and partly without the State.
>
> "Nor do we find that the method of apportioning the net income on the basis of the ratio of the segregated assets located in New York and elsewhere, was inherently arbitrary or a mere effort to reach profits earned elsewhere under the guise of legitimate taxation. The principal factors entering into this allocation are, as in the *Underwood Case*, the real and tangible personal property of the corporation. We see nothing arbitrary in also including bills and accounts receivable resulting from the manufacture and sale of merchandise and services performed, or in taking average monthly

values as the measure of all the segregated assets except shares of stock. And in the present case the inclusion of a portion of the shares of stock in other corporations,—none of which were allocated to New York—resulted in the Company's favor, and reduced the income allocated to New York to less than it otherwise would have been.

"It is not shown in the present case, any more than in the *Underwood Case*, that this application of the statutory method of apportionment has produced an unreasonable result. The fact that the Company may not have had any net income upon which it was subject to payment of income tax to the Federal Government, obviously does not show that it received no net income from the business which it carried on in New York. There is no evidence in the record as to whether the Company received any net income from its New York business, or the amount of the profit and loss on that business, if any, either considered separately or in connection with the manufacturing business carried on in Great Britain."

The *Underwood* and *Bass* cases hold that a statutory method of apportionment is not *per se* void and that a statute providing for such method of apportionment is not *per se* invalid. Appellant makes no contention to the contrary. The *Rees* case, however, establishes the principle that a statutory method of apportionment, albeit fair on its face, will not be sustained where it results unreasonably and arbitrarily. In other words, a statutory method of apportionment must yield to the requisite factual showing of the unreasonable and arbitrary consequence of its application. In the *Rees* case, according to the company's showing, about 17 per cent of its net income was reasonably attributable to the State of North Carolina as against approximately 80 per cent attributable to that state under the statutory apportionment formula. In the instant case although the formula method of apportionment attributed about 8 per cent of Appellant's total income to the State of California — $93,551.50 — nevertheless the agreed facts

clearly show that Appellant had no net income whatsoever in California, but rather an actual loss of $82,851. In the instant case, therefore, the statutory formula serves to convert a loss *in fact* of $82,851 into a "net income" of $93,551.50. Or, in other words, the statutory formula creates $175,000 of income out of nothing, or, as we have said, appropriates that much income from other states.

As stated, section 10 of the Franchise Tax Act professes an intent not to subject the taxpayer to double taxation, and it would seem obvious that the application by the court below of the statutory formula of allocation has violated such intent. It is agreed that Appellant's total income for the year in question was $1,149,000, and it was to this income that the state's percentage allocation was applied. But in determining that income there was taken into consideration the $82,851 loss in California. The result is that the remaining houses produced an income of $1,231,000, and it is upon that income that the other states are entitled to impose their respective taxes. If, then, the statutory formula is to be permitted to create a taxable income in California of $93,551.50 as against the actual loss of $82,851, the result is as a matter of plain necessity that there is an addition to the company's total income of $175,000—the difference between a net loss of $82,851 and a taxable profit of $93,551.50—thereby making Appellant's income for the year $1,324,000 instead of the $1,149,000. In this view it would seem to be obvious that Appellant is subjected to a double tax on this $175,000 of income which the court below has appropriated from Appellant's business conducted elsewhere than in California, and has given to California in order to create a tax.

We point out the foregoing not for the purpose of arguing in this court a mere question of statutory construction, but to point out the fact that the statutory formula taxes income not within the jurisdiction or control of the State of California.

If anything, the instant case is a clearer case for the invalidation of the tax than the *Rees* case.

The case of *North American Cement Corporation* v. *Graves*, 299 U. S. 517, seems to be the chief reliance of Appellee and the court below. In that connection Appellee seems to consider that the *North American Cement* case overruled the *Rees* case. We fail to see any basis for that view in view of the ground upon which the judgments of the New York courts were sustained, namely, that the statute

> "is valid upon its face, and it has not been shown to have been so applied as to violate Appellant's constitutional rights." (Citing the *Bass* case.)[1]

As to the *North American Cement* case the court below said that it holds that in the case of a unitary business "separate accounting in accordance with recognized accounting practice is insufficient evidence to disprove the propriety and presumption of fairness of formula allocation" (R. p. 34).

The case, we submit, holds no such thing, and the court below seems grievously to have misunderstood the decision. As a matter of fact the case did not involve, strictly speaking, a "separate accounting" method, rather, what is sometimes termed a so-called equitable method of apportionment.

In his petition in the court below for a hearing by that court after the decision of the District Court of Appeal, Appellee included a statement of the purported facts of the *North American Cement* case which it was said had been taken from volume 2253 United States Supreme Court records on file in the San Francisco City and County Law Library. Appellee stated that the company in that

1. The fact that the *Rees* case has been recently cited—*James* v. *Dravo Contracting Co.*, 302 U. S. 134; *Department of the Treasury of the State of Indiana, et al.* v. *Wood Preserving Corporation*, ... U. S. ....., decided April 28, 1941, does not suggest in any way that this Court regards the *Rees* case to have been overruled.

case, operating two cement plants in New York, one in Maryland and a lime plant in West Virginia, "operated its four plants separately and sold their products in separate districts, kept *separate accounts* for them, and sold very little of the output of the West Virginia and Maryland plants in New York." Appellee further stated that the New York Tax Commission applied an allocation formula to the entire net income of the corporation for the years 1925, 1926, 1927, and 1929, thereby allocating large income to New York for each year; that a reputable accounting firm each year made, certified and published an audit of the company's annual operations; that the certification of accuracy related to only one of the two New York plants, but because of the manner of preparation of the audit the certification also established that the accountants believed the report fairly showed the New York income." It was further stated that the accountants found it necessary to break down the company's profits and expenses into two categories, one within New York and the other without New York, and that having found the income and expenses earned within and without New York the accountants then segregated the New York income and expenses between the New York plants. The 1927 accounts were said to be representative and were set forth in the appendix to Appellee's petition.

We assume that the same material will be set forth in Appellee's brief in this court.

Appellee further stated that the results were certified by the accounting firm as accurately showing the results of the operations of the New York plant involved, and that it could be seen that under the method followed by the accountants "it was necessary correctly to show the results of the entire New York business before an accurate picture of part of it could be obtained. Thus the certification demonstrates that the accounting firm believed the accounting fairly determined the New York income."

Appellee further stated that by such "separate accounting method" a smaller income for 1925 was allocated to New York than by the formula method, and that for 1926, 1927 and 1929 large losses instead of income were allocated to New York.

It was then said that in the face of such evidence, this court, affirming the New York courts, held that the results of the formula were controlling and upheld the assessment based thereon.

Based upon the above analysis of the case, Appellee concludes that it held first that the operations of the four separate manufacturing plants, one of them making a different product from a different material, are so interrelated as properly to be treated as unitary, and second that "separate accounting in accordance with recognized accounting practices is insufficient evidence to disprove the propriety and presumption of fairness of the formula allocation."

Appellee has woefully misread and misconceived the case. The case is reported in New York Tax Cases, 1903 to 1906, New York Tax Service Supplement published by the Commerce Clearing House, Inc. at paragraph 94-285. The facts as there reported are taken from the brief of the Attorney General of the State of New York. It appears from that statement that the corporation reported net income in varying amounts for the years in question, and for the base year 1927 a net income of $272,663.50. In each of the years the corporation's returns showed the segregated assets between New York state and elsewhere. In 1927 the resulting New York percentage based upon such segregated assets was 56.7769 per cent.[1]

Taxes were assessed by the taxing officials upon the exact basis of the corporation's returns. Thereupon the

1. Apparently nothing was said in the company's returns about any so-called "separate accounting" nor was there apparently any claim made that the various plants were operated as separable units, or that the accounts of the various plants were kept separately.

corporation asked for an "equitable adjustment" of the taxes pursuant to section 211 of the tax law as in force in 1925.[1]

Thereafter a conference was held between the corporation and the Commission, and a formal hearing was had, at which time the statements [of the accountants] were submitted, and there was some testimony that the sales in New York by the out of the state plants amounted to "practically nothing." The statements and this testimony was the only evidence submitted by the corporation.

The corporation's total production of cement during 1927 was 3,387,595 barrels, of which 1,907,425 barrels, or 56.31 per cent of the total, was produced in New York. In 1929, one of the years involved, the New York production was more than 61 per cent of the total. The volume of production in the other two years, 1924 and 1925, did not appear. Upon that showing the assessment originally made was confirmed and such was apparently the record upon which the New York courts and this court were asked to invalidate the tax.

The accountants' statements set out, as we have stated, in Appellee's said petition in the court below, showed that there were two plants in New York—the so-called Howe's Cave plant and the Catskill plant—these two plants apparently being known as the Albany district. The Maryland plant and the West Virginia plant [the lime plant] were known as the Hagerstown district. It is clear from the statements, however, that there was no separate accounting by the New York plants, and for all that appears in the statements the various plants were not separated and segregated, nor were any of their accounts maintained separately. The accountants' statement included

1. Section 211 was held invalid in *People ex rel. Ducas Co., Inc.* v. *State Tax Commission*, 260 N. Y. 525, 184 N. E. 77, on the ground that the statute was so vague as to not constitute a workable rule for the guidance of the Tax Commission. From the report of the *North American Cement* case above mentioned it appears that the Attorney General conceded the invalidity of the statute in his brief.

an income account for the Catskill plant, which starts with net sales, cost of sales, and miscellaneous income, giving a gross income of $202,440.88. There was then allocated to the Catskill plant a percentage of the *total expenses* of the entire business of the company—34.44 per cent—which was the ratio of the cement shipped from the Catskill plant to the total cement shipped from all plants. The resulting expense thus allocated to the Catskill plant amounted to $258,501.07, leaving a net operating profit of $56,060.19. Against this operating profit was then charged interest and financial expenses amounting to $131,144.11, which again was based upon a percentage allocation. However, the accountants' statements further combined the so-called gross profit of the Howe's Cave plant and the Catskill plant, and then charged against such profit a percentage of the total expenses of the business of all kinds, based again upon the ratio of cement shipped from the two New York plants to the total cement shipped from all points. This resulted in a New York percentage of 56.31 per cent as against a percentage of 43.69 allocated to the out of the state plants. Also there was an allocation of the total interest and financial expense to the New York plants based upon the same type of percentage as was used in connection with the accountants' income statement with reference to the Catskill plant.

The result of all this was that the New York plants in 1927 showed a loss as against a total income from the company from all plants of the $272,663.50.[1]

While these statements undoubtedly appear in the record in that case before this court, we trust that Appellee will include them in his brief herein.

It must be obvious, therefore, that the situation in the

1. This situation seems very much like that involved in the *Norfolk and Western* case, 297 U. S. 682 where the gross income of the North Carolina mileage was determined by an allocation formula upon a percentage basis, whereas the expenses were claimed to be the actual expenses of such mileage. Hence the company used a percentage formula to determine revenue, but not expenses.

North American Cement case was nothing like that in the case at bar. Here, under the stipulation of facts, it appears that the San Francisco house was operated substantially as an independent unit and its accounts in fact were kept by the company upon a separate basis. The case at bar is not a case where, merely for the purpose of computing a tax, accountants put together an income statement for the plant within the taxing state. Whatever effect such accountants' statements or reports might have in appealing to the discretion of the taxing officials, they obviously have no probative value as evidence when the question of the validity of the tax becomes the subject matter of review by the courts. In the case at bar the accounts of the San Francisco house are a matter of evidence. They are not a matter merely of opinion on the part of the accountants. And such accounts were kept with respect to the San Francisco house in the due course of Appellant's business, and in the due course of the operations of the San Francisco house. They were not put together for the purposes merely of determining a tax or in order to try the present lawsuit.

It is inconceivable how this Court or the New York courts themselves could have arrived at any conclusion other than that the case was controlled by the *Underwood Typewriter* and *Bass* cases and that the evidentiary or factual situation did not meet the requirements laid down in the *Rees* case.

The principle followed in the *Rees* case was not at that time a particularly novel principle, inasmuch as it had theretofore been recognized and applied in numerous cases in this Court. In *Fargo* v. *Hart*, 193 U. S. 490, where the apportionment formula was held invalid, this Court said:

> "And when that property is part of a system and has its actual uses only in connection with other parts of the system, that fact may be considered by the State in taxing, even though the other parts of the system are outside of the state * * *.

"• • • It is obvious, however, that this notion of organic unity may be made a means of unlawfully taxing the privilege, or property outside the State, under the name of enhanced value or good will, if it is not closely confined to its true meaning."

In *Illinois Central Rd.* v. *Greene*, 244 U. S. 555, the tax was on an allocated proportion of the total capital stock—based upon the proportionate mileage within the State. The taxpayer introduced evidence showing that upon the particular facts of the case the statutory allocation produced an unfair result. This Court upheld that contention and held the statute invalid, saying:

"• • • although the fact that property is part of a system and has its actual uses only in connection with other parts of the system may be considered by the State in taxing that portion of the system which is within its borders, yet the notion of organic unity must not be made the means of unlawfully taxing property without the State."

In *Union Tank Line* v. *Wright*, 249 U. S. 275, where a formula allocation was also held invalid because of the factual situation, this Court said:

"How to appraise them [the properties sought to be taxed] fairly when the tangibles constitute part of a going concern operating in many states often presents grave difficulties; and absolute accuracy is generally impossible. We have accordingly sustained methods of appraisement producing results approximately correct—for example, the mileage basis in case of a telegraph company, and the average amount of property habitually brought in and carried out by a car company. But if the plan pursued is arbitrary and the consequent valuation grossly excessive, it must be condemned because of conflict with the Commerce Clause or the Fourteenth Amendment or both • • •.

"• • • Taxes must follow realities; not mere deductions from inadequate or irrelevant data."

Wallace v. *Hines*, 253 U. S. 66, involved an excise tax upon the doing of business in the State—based upon the

total value of property proportioned in accordance with the main line mileage in the state and elsewhere. In invalidating the tax measured in this fashion because of the factual situation, this Court said:

> "The only reason for allowing a state to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of the things within it, when they are part of an organic system of wide extent, that gives them a value above what they otherwise would possess. The purpose is not to expose the heel of the system to a mortal dart—not, in other words, to open to taxation what is not within the state. Therefore no propery of such an interstate road situated elsewhere can be taken into account unless it can be seen in some plain and fairly intelligible way that it adds to the value of the road and the rights exercised in the state."

In *Southern Ry.* v. *Kentucky*, 274 U. S. 76, involving a franchise tax based upon an allocation of income dependent upon the proportionate mileage within the state, this Court said:

> "The mileage used as an integral part of a railroad system may have elements of value that it otherwise would not possess, and the state property may have regard to the whole in order to ascertain the value of the part that is within its borders. • • • But if the method pursued in valuing property within the state is arbitrary and the resulting valuation is grossly excessive the tax must be condemned as in contravention of the due process clause of the 14th Amendment."

In that case the evidence indicated that the Kentucky lines were operated at a loss, whereas the system as a whole showed a net profit. Apparently the court considered the factual showing in that regard to be adequate.

In *Nashville C. and St. L. Ry.* v. *Browning*, 310 U. S. 362, this Court said (p. 365):

> "The problem to be solved is what portion of an interstate organism may appropriately be attributed to

each of the various states in which it functions. Basic to the accommodation of these conflicting state and national interests is realization that by its very nature the problem is incapable of precise and arithmetical solution. In tapping these common sources of revenue a state cannot, we have held, use a fiscal formula, whatever may be its appearance of certitude, to project the taxing power of the state plainly beyond its borders."

Citing:

Wallace v. *Hines*, 253 U. S. 66.

Wallace v. *Hines*, is referred to by the court below in connection with its quotation from the opinion of the *Bass* case (R. p. 31), but without any recognition of the fact that in that case the formula was stricken down—even though the decision recognized that, absent the requisite factual showing, a formula allocation not *per se* unreasonable or arbitrary might be sustained.

The *Nashville* case last above cited does not impair any of the earlier decisions of this Court above cited. In that case the court was dealing with a property tax and the question was as to the proper valuation of the company's lines in Tenessee. The Tennessee lines were valued upon a basis proportionate to the line's Tennessee mileage. The company's objection to the valuation of the Tennessee property as such was that it failed to produce a commensurate income. Obviously the question of income is not of itself controlling on the question of an *ad valorem* tax on the property itself—even though it is properly one factor for the consideration of the assessment officers. However, as to the earlier cases this Court said:

"Wherever the states' taxing authorities have been held to have intruded upon the protected domain of interstate commerce in their use of a mileage formula, the special circumstances of the particular situation, in the view which this Court took of them, precluded a

defensible utilization of the mileage basis. * * * No such circumstances are here presented."

The opinion and reasoning of the state court in the *Rees* case closely resembles that of the court below in the instant case,—even though, from the standpoint of the question of a "unitary" business, the instant case with its separate branch houses is far removed from the manufacturing business in the *Rees* case. When we consider that the underlying reason for applying an allocation formula to total net income to arrive at the income properly attributable to the taxing state is that the one contributes to the whole of the income, we see how little application such a formula allocation has in the case of a business like that of Appellant, where each of its branch houses is operated substantially as an independent business and the results in any one house have little, if any, bearing upon the operations at another house. And when we also see that in the instant case a loss has resulted in California even though the San Francisco house benefited from Appellant's aggregate purchasing power by being charged for its merchandise only the actual cost thereof plus transportation to San Francisco, we see how unreasonable and arbitrary it is to apply an allocation formula where the result is to create income where none exists in fact.

It appears from paragraph 7 of the stipulation (R. p. 10) that the allocation percentage is based upon Appellant's real and tangible property within and without the state, wages, salaries, etc., within and without the state, and gross sales within and without the state. It is difficult, if not impossible, to conceive how, in view of the manner in which Appellant's several houses are operated, the amount of merchandise or other property, including real estate, owned by the company in other states, or the amount of its payroll, etc., in other states, or even its gross sales in other states, have, or could have, any direct bearing upon

the results of the operation of the San Francisco house. That property, those wages and salaries, and those sales could be more or less in amount in dollars in other states without materially affecting the results of the San Francisco house whatsoever. And we say this although the stipulation in paragraph 7 further provides that no question is raised respecting the use of the formula in question "if by reason of the facts stipulated herein a formula for application to California of a portion of the company's income from all sources is proper."

In other words, the stipulated facts, we respectively submit, clearly demonstrates the inapplicability of the statutory formula where the California income can be otherwise reasonably and accurately determined.

II.

THE FACT THAT A BUSINESS IS "UNITARY" IS NOT CONTROLLING IN DETERMINING THE LEGALITY OF A STATUTORY FORMULA METHOD OF APPORTIONMENT.

The court below says in its opinion (R. p. 28):

> "If there is any evidence to sustain a finding that the operations of appellant in California during the year 1935 contributed to the net income derived from its entire operations in the United States, then the entire business of appellant is so clearly unitary as to *require* a fair system of apportionment by the formula method in order to prevent overtaxation to the corporation or undertaxation by the state." (Italics ours.)

The *Underwood* case is cited in support of that statement. The opinion further states (R. p. 27):

> "The answer to this question [the legality of the formula method of allocation] depends entirely upon the nature of the business conducted within and without the state by appellant, a foreign corporation. It is only if its business within this state is truly sep-

arate and distinct from its business without this state, so that segregation of income may be made clearly and accurately, that the separate accounting method may properly be used."

In the first place, no decision of this Court supports any such view as that expressed by the court below in the last above excerpt from its opinion. And even if it were supported by any decision of this Court, the Court's action in the instant case conclusively demonstrates that the language in question is, and can be, given no practical force or effect. Appellant's business operations in the State of California are far more susceptible of segregation and separation from its operations in other states than in the case of a mere manufacturing business like that involved in the *Underwood* and *Bass* cases, and in the *Rees* case. And even in the case of a rail carrier the rule of the *Rees* case applies if the factual situation warrants,[1] although the lines of an interstate carrier are less susceptible of segregation and separation than most any kind of business conceived of. Yet in those types of businesses the fact that the business is unitary is not of itself a controlling factor. As was said in the Rees case:

"Undoubtedly, the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business, and all the factors in that enterprise are essential to the realization of profits. The difficulty of making an exact apportionment is apparent and hence, when the State has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases. But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income

1. *Norfolk & Western Ry. Co. v. Maxwell*, 297 U. S. 682.

may be taxed in one State regardless of the extent to which it may be derived from the conduct of the enterprise in another State. * * * When, as in this case, there are different taxing jurisdictions, each competent to lay a tax with respect to what lies within, and is done within, its own borders, and the question is necessarily one of apportionment, evidence may always be received which tends to show that a State has applied a method, which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction."

III.

THE FACT THAT THE TAX IS AN EXCISE TAX IS IMMATERIAL.

It may be contended by Appellee that a statutory formula for allocating income to the taxing state will be sustained where the tax is an *excise* or *franchise* tax, even though it might not be sustained where the tax is an income tax. This contention necessarily goes to the extent of saying that the decision in the *Rees* case does not apply in the case of an excise or franchise tax as distinguished from an income tax. This distinction has no support in the decisions of this Court.

As heretofore pointed out, the statute involved in the *Underwood* case was not clear as to what type of tax it imposed. The state contended that the tax was in the nature of an excise tax. Others contended that the tax was a property tax, and still others contended that the tax was an income tax. The Connecticut court held that the tax was an excise tax levied upon the privilege of doing business in the state. In this Court it was said (254 U. S. 113, at p. 120):

"In considering this objection we may lay on one side the question whether this is an excise tax purporting to be measured by the income accruing from business within the state or a direct tax upon that

income; for the 'argument upon analysis resolves itself into a mere question of definitions and has no legitimate bearing upon any question raised under the Federal Constitution.''

The New York statute involved in the *Bass* and North American Cement cases was an excise tax. Neither case was decided upon any distinction between an excise or franchise tax and an income tax. The North Carolina statute involved in the *Rees* case was in terms a tax upon net income, but was said by the North Carolina court to be substantially identical with the Connecticut statute construed in the *Underwood* case (103 S. E. at p. 853). We take it, therefore, that the North Carolina statute must also be regarded as an excise tax, with the result that the *Rees* case did involve an excise or franchise tax and not an income tax as such.

The California statute here involved has been considered by the California court to lay an excise or franchise tax. *Matson Navigation Co.* v. *State Board*, 3 Cal. (2d) 1, 43 Pac. (2d) 805, affirmed, *Matson Navigation Co.* v. *State Board*, 297 U. S. 441; *Pacific Co.* v. *Johnson*, 212 Cal. 148, 298 Pac. 489, affirmed *Pacific Co.* v. *Johnson*, 285 U. S. 480. In all of the cases dealt with by this Court the ultimate decision has turned upon the factual situation and not upon any claimed distinction between an excise or franchise tax and an income tax.

In connection with the *Matson* case above mentioned, the court below states in its opinion (R. p. 36) that the formula method of allocating or apportioning income in the case of a unitary business was there approved. We do not so read that case. The *Matson* case involved domestic corporations, and the question was as to whether the statutory formula should be applied to a base which included receipts from interstate and foreign commerce. The companies contended, first, that the statute should not be interpreted as including such receipts in the tax base, and, second, that if

they were to be so included the statute was void. The California court held that the tax base should include receipts from interstate and foreign commerce and its decision in that regard was affirmed by this court. There is no such question in the instant case. The San Francisco house included in its gross receipts sales made throughout its own territory, including receipts from all interstate sales. No claim has ever been made by Appellant that the receipts of the San Francisco house derived from sales in interstate commerce should be excluded. In the *Matson* case this Court said (297 U. S., at pp. 444, 5) that the question in the *Rees* case "was as to the apportionment of income to the taxing state," and that the controversy in the then case [the *Matson* case] concerned the amount "to be paid for the privilege of using in California corporate franchises granted by that state" to the companies, and that "no question of apportionment is here involved."

IV.

APPELLANT'S BUSINESS IS NOT UNITARY.

The decision of the court below is premised entirely upon the proposition that Appellant's business is unitary. The court, therefore, concludes, as we have said, that a statutory formula allocation is not only required by the statute itself but is necessarily valid from the constitutional standpoint—wholly irrespective of the factual situation involved. We contended in the court below, and we here contend, that in fact Appellant's business is not unitary. The term "unitary" is not a term having any particular legal concept. The term is used to convey an idea, which was stated by this Court in the *Rees* case, that "the ultimate gain is derived from the entire business." We think there should be added to this statement some further qualification which imports some continuity of operation, as in the case of a

manufacturing business where the goods are manufactured in one state and then transported to other states for sale. In the instant case Appellant does not manufacture, and the actual merchandise sold at the various houses is manufactured at various locations throughout the United States. It is true that all merchandise is centrally purchased at Appellant's headquarters at Chicago, but this simply means that the buying offices are located at Chicago where the buyers carry on such buying operations. The merchandise itself is not stored at headquarters but is shipped to the various houses directly from the various factories and mills. Appellant's central buying division is not at all comparable to a manufacturing plant.

Appellant's only business is that of selling to retailers the merchandise which it purchases. The sales and other attendant activities are severally conducted at Appellant's seven houses, each of which serves its own trade territory, maintains its own stock of goods, and handles its own solicitation, sales and credit arrangements. Goods purchased from manufacturers are shipped directly to these various houses, from which they are, in turn, shipped to the company's customers. The greater part of all operating expenses are directly and exclusively incurred at the respective houses. These direct expenses, together with the cost of goods purchased for resale, amounted to approximately 98 per cent of the total expense of the San Francisco house in 1935.[1]

It is stipulated (R. p. 9; Stipulation of Facts, par. 4) that except for the common expenses allocated to the various houses, each house is operated independently of each other house. These common expenses consist of "executive salaries, certain accounting expenses, the cost of operating a central buying division, and a central adver-

1. Sales of the San Francisco house in 1935 amounted to $5,200,000. (R. p. 18.) The net loss was $82,851 (R. p. 17), indicating a total operating cost of $5,088,851. Of this only $100,091 represented allocation of common expenses. (R. p. 16.) This $100,091 is less than 2 per cent of the total expense of the San Francisco house.

tising division" (Stipulation, Par. 4; R. p. 9). Paragraph 3 of the stipulation states that in the case of the central buying division no charges are made against any house for the benefit of the company or any other house by reason of such centralized purchasing, but the actual cost of operating the centralized buying division is allocated to the houses (R. pp. 8-9).

Paragraph 4 of the stipulation explicitly states that "no question exists as to the accuracy of the amounts of such expense or to the method of allocation employed, which is in accordance with recognized accounting practices." (R. p. 9.)

In the case of a manufacturing business, obviously without sales offices and without any sale of goods the factory is of no value and produces no income. In the instant case the San Francisco house could be closed at any time without any especial effect upon the remainder of the Appellant's business carried on at its other six houses. In other words, there is no continuity of any kind as between Appellant's business as a whole and the San Francisco house. According to paragraph 9 of the stipulation (R. pp. 10-11) an amount of purchases equal to those made for the account of the San Francisco house results in no more favorable prices than could be obtained in respect to purchases in an amount equal to the purchases which would be made by the company for its other houses if the San Francisco house were not in existence, and a reduction in the volume of purchases in an amount equal to the purchases made for the San Francisco house would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the company. In other words, the existence of the San Francisco house neither adds to nor detracts from Appellant's aggregate purchasing power, and none of Appellant's other houses is in any way dependent upon the San Francisco house for its continued existence. Obviously

in the case of a manufacturing business the sales offices are dependent upon the factory for merchandise, and in turn the factory is dependent upon the sales offices for the moving of the merchandise. Appellant's various houses are about as separate and distinct operating units as is possible to have. The fact that the purchasing operations are carried on at headquarters for the benefit of all of Appellant's branch houses is entirely immaterial.

That confusion exists in the mind of the court below is demonstrated, we believe, by what is said with reference to the so-called buying profit. It is said (R. p. 29):

> "It is our opinion that the sales made in each of the seven states in which appellant does business must be proportionately credited with the profits resulting from the purchasing power which such sales in the aggregate produce."

It would seem obvious that the benefit to Appellant as a whole from its aggregate purchasing power cannot exceed the difference between the prices actually paid for merchandise and the prices which would have been paid had purchases been made separately for each house alone. It would seem equally obvious that to effect proportionate distribution of that saving each house must be credited with that fraction of the total savings which the purchases made bear to the total. When, therefore, as here, only the actual cost of the goods purchased for the account of the San Francisco house is charged to that house it has received in fact its full proportionate measure of the purchasing saving of the company as a whole. And this can be done in no other way. Only if it should appear that each of Appellant's houses—and the San Francisco house in particular—is charged with merchandise at a price higher than the actual cost thereof, could it be said that that house is not proportionately credited with the profits resulting from the purchasing power of the company as a whole. Therefore when it absolutely appears, as it does in the instant case by the stipulation of the parties, that each

of Appellant's houses—and the San Francisco house in particular—is charged for its merchandise only with the actual cost thereof, then the court's statement above mentioned is clearly shown to be without merit or substance. If, as the court below says, the San Francisco house purchases may not be ignored, then to a corresponding extent the purchasing advantages of Appellant as a whole cannot be attributed to the San Francisco house beyond its fair contribution thereof. As to this the court below says (R. p. 28):

> "By its large scale purchasing activity, appellant concededly is able to buy at lower prices than would otherwise be possible, thus realizing a purchasing saving. But it is able to buy in large quantities only because it is able to sell in large quantities, so that it is apparent that the purchasing saving is made possible only because of the sales."

We take it that this statement of the court is but a restatement of the last sentence of paragraph 8 of the stipulation (R. p. 10) that—

> "By reason of the volume of purchases made by the Company more favorable prices are obtained than would be obtained in respect of purchases for the account of any individual house operated by the Company."

But we still inquire, what of it? The fact still remains, as the court below itself recognizes, that the parties have agreed that the purchases made for the account of the San Francisco house have no effect whatsoever upon the company's aggregate purchasing power. (Stip. Par. 9, R. p. 10.) The court seems to dismiss paragraph 9 of the stipulation with the bare statement (R. p. 28) that Appellant had urged that the "San Francisco store is the one which does not affect purchase price differentials." But in this connection it is not merely what Appellant urges, but rather it is what the stipulation states, and it is not competent for the court below to go in back of the

stipulation and find the fact other than what the stipulation states the fact to be.

There is nothing inconsistent so far as we can see in agreeing that the company's total volume of purchases at all houses enable it to buy at lower prices than if each house purchases separately, and at the same time to agree that the addition or subtraction of purchases equal to those made for the account of the San Francisco house would not affect at all Appellant's aggregate buying power. That is what the stipulation has provided. So again we see that when the San Francisco house is charged with merchandise at the actual cost thereof it has received the greatest possible benefit of Appellant's aggregate purchasing power and has in fact received its full proportionate share of the profit resulting from the company's aggregate purchasing power.

Appellee's point seems to us to be fully met by the California District Court of Appeal in its opinion herein. (R. p. 22.) The court said:

> "They [the State] contend that the disposal of some $5,000,000 worth of merchandise during the time mentioned increased the purchasing power of Appellant and thus permitted it to buy for its other houses through volume purchases at a price lower than it otherwise would have secured. It appears, however, that the parties have stipulated otherwise. We quote from the agreed facts: 'A reduction in the volume of purchases made by the San Francisco house would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the Company.' "[1]

1. The above quotation is taken from the record as it is. (p. 22.) There was a slight modification by the Court of Appeals of its said opinion when the State, in its petition for rehearing in that court, called attention to the fact that there was an inaccuracy in the court's quotation from the agreed facts. The actual wording in the stipulation was that "a reduction in the volume of purchases *in an amount equal to the purchases* made for the San Francisco house." The words in italics were the words omitted by the court in its statement. The court of appeals, however, for purposes of accuracy, directed that its opinion be modified accordingly, saying in that connection: "No point is made by respondent

In its opinion denying the rehearing the court of appeals said:

> "It is stated that the court failed to note certain stipulated facts covering the effect of volume purchases. Such facts were not omitted. They also appear in the statement given earlier in the opinion. They may state a *general* law of economics but as the parties had definitely stipulated with reference to the operations of the San Francisco branch the latter facts must control as applying to this specific instance."

And by way of conclusion in its original opinion the court of appeals said (p. 24):

> "We therefore conclude that the stipulated facts show that the company actually incurred a loss in California; that its California earnings could have been accurately ascertained without the necessity of recourse to any arbitrary formula, and that the use of such formula results in the imposition of a tax not earned in California and therefore not subject to its taxing power."

There are a number of cases in the state courts which may well be considered.

In *J. G. McCrory Co.* v. *Commissioner*, 280 Mass. 273, 182 N. E. 481, taxpayer was a corporation which, with some sixteen other corporations, was owned by the McCrory Stores Corporation—the parent company. McCrory stores are retail stores operating as part of a chain, although each individual store happens to be separately incorporated. Generally speaking such stores are of the same general type as the large integrated variety retail chains like Woolworth & Company, or dry goods stores like the Penny and Grant Stores, and like the large retail catalog houses like Montgomery Ward and Sears, so far at least as concerns their retail outlets.

[the State] arising out of the omission of the words used. Furthermore, such words appear in the statement of facts given in the opinion before such quotation was used.

The opinion as thus modified appears in the report of the case in 102 Pac. (2d) 776 at page 779.

In all of these cases all of the stores are under a common management and control, and all merchandise is bought through a central buying agency.

In the McCrory case the Commissioner assessed the tax based upon a percentage of the consolidated income of all of the stores, although according to the evidence the store located in Massachusetts operated at a loss. In that case the merchandise was charged to the retail stores at cost plus a service charge or commission of 10 per cent. Only to this extent was any effort made to attribute any part of the buying profit to the central buying agency. Likewise, as in the case of Appellant, each individual store was charged with a certain proportionate part of certain overhead expenses, etc. The company insisted that its income was to be determined for tax purposes in accordance with the actual figures pertaining to the store, and this claim was sustained by the Massachusetts court. While in that case the court made some mention of the fact of the separateness of the corporate entities, the basic reason for sustaining the company's position was that the income of the Massachusetts store could be accurately and reasonably determined through its own accounting figures, and that to assign to Massachusetts any of the income received by the remaining McCrory stores was to attribute and tax income in Massachusetts which did not exist in that state. The court said in its opinion that cases like the *Underwood Typewriter* case were essentially unlike the case with which it was then dealing, and that its conclusion was in harmony with the *Rees* case.

The opinion of the court below mentions a number of other state court decisions. To one of them—*Standard Oil Co.* v. *Wisconsin Tax Commission*, 197 Wis. 630, 223 N. W. 85—the opinion devotes considerable space (R. p. 34). With all due respect to the California court, we do not understand the distinction which it asserts with respect to the Wisconsin case. In the Standard Oil case plaintiff did

business both within and without Wisconsin. It owned extensive refineries outside of the state. It maintained numerous tanks and filling stations within the state. About 54 per cent of the company's products were sold within the State of Wisconsin and 46 per cent outside the state. The assessment made by the Commission was arrived at by determining a fraction which resulted from averaging the percentage of the tangible property within the state to the total tangible property everywhere, the percentage of manufacturing cost within Wisconsin as compared with the total manufacturing costs, and the percentage of sales within Wisconsin as compared to the total sales. The resulting fraction was about 4 per cent. This percentage was applied to the company's total income, the resulting taxes amounting to some $156,000. The company claimed that its Wisconsin income should be determined in accordance with the actual operation of the Wisconsin business. In that connection it appeared that the Wisconsin business was charged with the products sold at market price rather than mere cost. The result of this was that part of the so-called manufacturing income was attributed to states other than Wisconsin. The company's method produced an income attributable to Wisconsin of $1,273,413, and a tax of about $89,000. The court sustained the company's position, saying:

> "In the enactment of the statute relating to the allocation of income of persons doing business within and without the state, the declared legislative purpose is to make a reasonable and equitable distribution of the taxpayer's income to the end that that part of the income justly assessable in the state of Wisconsin may be ascertained. The statute does not enjoin upon the commission the use of that method which will produce the largest amount of taxable income but rather that method which will most justly apportion the income properly taxable in Wisconsin. *Here it appears conclusively that it is possible to ascertain the income derived from business transactions in Wisconsin by*

the application of proper accounting methods. It appears without dispute that the tax commission has had full access to all the records of the plaintiff company and has been given every opportunity to confirm the correctness of the statements submitted to it by the plaintiff." (Italics ours.)

The court distinguished the *Underwood Typewriter* case, stating that there was nothing in that case inconsistent with its holding in the case before it. In that connection the court said that there was no reason why the profits derived from the sale operations in Wisconsin should not be ascertained (223 N. W. at p. 88.)

"as they would be if the sales operations were conducted by a separate corporate entity. In either case the profits were earned at the same time and place."

The court below criticizes the Wisconsin case because it did not attribute to Wisconsin the whole of the manufacturing profit—*i. e.*, because the Wisconsin business was charged with the goods sold at *market price* rather than cost. But even if the criticism were just the instant case would not be affected inasmuch as here Appellant's San Francisco house is charged only with the actual cost of the merchandise and thereby it receives its proportionate share of the so-called buying profit. Even if in the Wisconsin case the Oil Company's Wisconsin business were charged only with the *cost* of the product sold by it, the case would still stand as authority for invalidating a tax based upon a percentage of the company's total income where the income attributable to the particular taxing state—there Wisconsin—could be reasonably and accurately determined as a separate operating unit.

The court below also cites *International Elevator Co.* v. *Thoresen*, 58 N. Dak. 776, 228 N. W. 192, as holding that "the unitary character of the buying and selling business" was recognized. (R. p. 35.) In that case the company maintained elevators in North Dakota and Montana and

sold grain in various states, principally at Minneapolis and Duluth. The company insisted on determining its income based upon receipts from sales made in North Dakota alone. The state applied a statutory formula to determine the income, and apparently no question was made as to the use of the formula if the income was not to be limited solely to North Dakota sales. The court overruled the company's position, thereby attributing to North Dakota an income not limited merely to sales of grain in North Dakota. We have no particular criticism to make of that decision as the case was presented to the court for decision. The question there was no different than had the Rees Company in the *Rees* case claimed that its manufacturing profit in North Carolina was limited solely to sales of leather goods made in the State of North Carolina.

We do not see that the North Dakota case is any support for the decision of the court below—certainly not from the standpoint of the Federal question involved.

Montgomery Ward & Co. v. *State Tax Commission*, 151 Kas. 159, 98 Pac. (2d) 143, is sometimes taken as sustaining a separate accounting method as against the allocation method. There was no issue, however, in that regard, between the company and the taxing state, the issue there, as we read the case, being as to whether or not the Kansas stores should be charged for merchandise upon a basis greater than the actual cost. In its actual operations in Kansas the Ward stores were charged with merchandise only at the cost thereof—none of the so-called buying profit being attributed to the central buying headquarters as such. In its tax returns, however, the company insisted that the merchandise should be charged to the Kansas stores upon a basis greater than cost in order that a reasonable part of the buying profit should be attributed to localities other than Kansas. The company's position in this regard was sustained by the Kansas court.

Were Appellant here contending that all or part of the so-called "buying profit" should be attributed to Illinois, where Appellant's principal office is located and its buying operations are carried on, in other words, that the San Francisco house, in determining its profit or loss, should be charged with the merchandise sold by it at some amount greater than the actual cost thereof—Appellant could properly urge the Kansas decision as supporting its position. Likewise the *Standard Oil* case would also support that position. In the *Standard Oil* case, however, the court not only dealt with the specific question last mentioned, but went further and required the Wisconsin income to be determined upon its own footing where such income could be reasonably and accurately determined by the actual figures pertaining to the Wisconsin business, and refused to sanction a statutory formula method of allocation.

The court below, as to the *Standard Oil* case, seems to confuse those two questions and goes off, in its criticism of the *Standard Oil* case, upon the sole question relative to the manufacturing profit of the company. The court below seems to ignore entirely the other basic question considered by the Wisconsin court as to the inapplicability of a formula method of allocation where the income within the taxing jurisdiction is otherwise reasonably and accurately susceptible of determination.

As we read the State's argument in the Wisconsin case, and we believe the Wisconsin court so understood the argument, it was that Standard's business was unitary and that therefore the only accurate way of determining the income from the Wisconsin business was on the basis of an allocation formula. See 223 N. W. at p. 87. It was in that connection that the Wisconsin court said that:

> "• • • it appears conclusively that it is possible to ascertain the income derived from business transactions in Wisconsin by the application of proper accounting methods."

In *Standard Oil Co.* v. *Thoresen*, C. C. A. 8, 29 Fed. (2d) 708, the Tax Commissioner of North Dakota applied an allocation formula. After holding that

> "the legislature of the state, in enacting the statute above quoted, did not intend to impose a tax on the property of the plaintiff company or its income from the doing of business other than the character of business done in the State of North Dakota, that is, selling oil in that state."[1]

the court said (p. 711):

> "There can be no question whatever but that any statute of a state which attempts to tax property located in another state is void and beyond the power of the state. * * *
>
> "This position, we believe, is conceded by the state; but the contention here made by the state is this: The business of plaintiff may and should, for the purpose of taxation, be regarded as a unit in the production, transportation, refining and marketing of oil. From a reading and consideration of the many cases on the subject we are not of that opinion. In some cases the unit theory of taxation, attempted to be here applied is all right and has been upheld by the Supreme Court of our country in such cases as *Underwood Typewriter Co.* v. *Chamberlain, Treasurer of State of Conn.*, 254 U. S. 113, * * * and in *Adams Express Co.* v. *Ohio*, 165 U. S. 194 * * *."
>
> * * * * *
>
> "The plaintiff in this case is engaged in the production of crude oil in those states wherein crude oil is found. There is no crude oil discovered in the state of North Dakota. The plaintiff has also engaged in the manufacture and refining of crude oils in many states, but has not done so in the state of North Dakota. It has engaged in marketing refined oil alone in that state. On its properties within the state of North Dakota employed in the business of marketing oil, and on the income arising from the doing of that business

1. The California statute here involved professes a like intent. See section 10, *supra*, p. 2.

within the state of North Dakota it may be there taxed by the state and the tax must be paid. On its business of producing and refining oil it should be taxed only by the state in which this production is found or refining done. In the manufacture or refining of crude oil in different states it must be taxed and pay its taxes within said states; others, not engaged in the production or refining of oils, engaged in the marketing of refined oils in the state of North Dakota. It is conceded to be a very easy matter for the state to determine the market value of refined oils within its borders at any time and place, and on this, having ascertained the selling price, to determine the tax necessary to be paid."

The application of the statutory formula was held improper.

The same reasoning and principle applies to the instant case. Appellant's San Francisco house is conducted just the same as any of its competitors' businesses in that state, including competitors doing business wholly within the state of California. Whether Appellant makes a profit in some one or more of the other states, or incurs a loss in those states has no reasonable relevancy to its operations in California. And we believe without question that had Appellant suffered large losses in states other than California, and had had a profit in that state, Appellee would have been the first to disclaim the statutory formula of allocation. Whether in a given year or under given circumstances the taxing state gains or loses by the application of a statutory formula is a purely fortuitous circumstance. Here again the remarks of the Wisconsin court are pertinent when it said (223 N. W. 88):

"The statute does not enjoin upon the Commission the use of that method which will produce the largest amount of taxable income, but rather that method which will most justly apportion the income properly taxable in Wisconsin."

A similar decision appears in *Fisher, State Treasurer of North Dakota* v. *Standard Oil Co.*, C. C. A. 8, 12 Fed. (2d) 444, wherein it was said:

> "The theories of allocation can have no place in the inquiry if net income within the state stands on its own footing, unmixed with outside business." Citing *Wallace* v. *Hines*, 253 U. S. 66.

See, also:

Standard Oil Co. v. *Howe*, 257 Fed. 481.

The court below also cites *Great Atlantic & Pacific Tea Co.* v. *Grosjean*, 301 U. S. 412. That case is quite inapposite here. There this court sustained a chain store tax measured by the total number of stores in the chain, either within or without the State of Louisiana. We do not see that the remarks of the court below as to that case (R. p. 36) have any special significance.

On the question of the significance of a "unitary" business the remarks of the Utah Supreme Court are in point. In *Utah-Idaho Sugar Co.* v. *Salt Lake County*, 60 Utah 491, 210 Pac. 106, 114, the court said:

> "The doctrine never has been applied, however, nor can it justly and equitably be applied, to manufacturing or other similar plants or industries which may be under common ownership, but used or operated in different states. Taking plaintiff's numerous plants as an illustration, in the very nature of things they are, precisely as the court found, operated and used entirely independent of one another. The failure or even the destruction of one factory or plant has no effect upon any other one. Neither is the property used in connection with those plants, or any part of it, used at any one time in one state and at another time shifted or moved to another state. But the plants and the property used in connection therewith are just as stationary and immovable as though each one was owned by a different individual or corporation. All there is, therefore, is a unity of ownership, which, as a matter of course, cannot control either local or general taxation."

In *State* v. *Lion Oil Refining Co.*, 117 Ark. 209, 284 S. W. 33, 36, the court said:

> "• • • it is manifest that there can be no organic relation between its plants situated in different states, and there can be no connected use of these plants within the rule laid down • • •. Each one could be separately operated and might be shut down without any impairment of the operating power of its other plants in the other two states."

While the views of the Arkansas court and perhaps the Utah court may be too restricted in considering that the unit rule of taxation should be applied only to carriers and the like and not to manufacturing or oil companies, nevertheless their view as to the separableness of the corporate operations is in point.

The term "unitary" is defined in *Maxwell* v. *Kent-Coffey Mfg. Co.*, 168 S. E. 397, 399, as follows:

> "It is admitted in the brief for appellee that its business is unitary. That term is simply descriptive, and primarily means that the concern to which it is applied is carrying on one kind of business—a business, the component parts of which are too closely connected and necessary to each other to justify division or separate consideration, as independent units. By contrast, a dual or multiform business must show units of a substantial separateness and completeness, such as might be maintained as an independent business (however convenient and profitable it may be to operate them co-jointly), and capable of producing a profit in and of themselves."

The above opinion is that of the North Carolina court whose decision had been reversed by this Court in the *Rees* case. And certainly the North Carolina court in the above *Kent-Coffey* case had no misconceptions as to what its own views were as expressed in the *Rees* case, and what the views of this Court were as expressed in the same case upon appeal.

It is conceded, of course, that Appellant's seven branch houses have unity of ownership. Nevertheless the fact is, as the stipulation states, that Appellant's seven houses are

separate and distinct business units. They have no "organic unity" or "unity of use," but on the contrary have a "substantial separateness and completeness such as might be maintained as an independent business."

There is no magic in the term "separate accounting." This Court, in determining the constitutional question, is not concerned with mere descriptive terms or adjectives. The point of the *Rees* case and the principal which is recognized in all of the other cases relied upon by Appellee, is that if the income within the taxing state can be determined with reasonable accuracy then there is no constitutional room for the application of a statutory formula when the income determined upon the basis of such formula is far in excess of the income in fact.

Where the business operations of a taxpayer doing business in several states is of a separable and individual character sufficiently so that the results of its operation can be reasonably and accurately determined by itself, then the tax can constitutionally be layed only with respect to the actual income within the state. The Georgia court has summed up the proposition very concisely in a recent decision. *Mexican Petroleum Corporation of Georgia* v. *Head*, 13 S. E. (2d) 887. After construing the Georgia statute to tax all corporations only upon that portion of their business reasonably attributable to the trade or business within the state, the court considered the propriety of an allocation formula. The court said:

> "Where the business done within the State is distinctly divisible from the business done in other jurisdictions by the same corporation, ordinarily the total income from all operations can not be used as a basis of computation. See 75 L. Ed. 900, annotation. * * * The theories of allocation can have no place in the inquiry if the net income within the State stands on its own footing unmixed with outside business."

Among other cases referred to by the court was the *Rees* case.

V.

APPELLANT HAS NOT ACCEPTED AN ALLOCATION FORMULA IN PART AND ATTACKED IT IN PART.

Appellee contends that this Court has held that the formula method of allocation cannot be accepted in part and attacked in part. Reference is made to *Norfolk & Western Ry. Co.* v. *Maxwell*, 297 U. S. 682. Appellee's contention in this respect differs somewhat from the contention of the California Supreme Court also based upon the *Norfolk & Western* case. The court below said (R. 37):

> "As appellant has failed to show a variance from normal in either the California sales, property or payroll, or in either expenses or revenue, it is our conclusion that appellant has not upheld its burden of proof, for in order to overthrow a formula the taxpayer must introduce such evidence and the evidence must go to each element of the formula equation."

What Appellee means is that there were certain expenses in the way of general overhead and the like which necessarily had to be divided up or allocated among the various branches or divisions of Appellant's business, which expenses were allocated upon a percentage basis. If Appellee's contention in this regard were correct it would never be possible to determine a separate income in any one state in the case of a corporation doing business in various states under a single management or control inasmuch as there must always be in such cases some sort of an allocation of the common expense among the various states.

In view of Appellee's contention and of the court's statement, we take time to state what we understand the holding in the *Norfolk & Western* case to have been. In that case taxable net income of interstate railways was based upon the proportion of mileage within the state to the railroad's total mileage. Under the apportionment formula the "gross revenues" were first determined by the mileage ratio and

the gross expenses, also determined by the mileage ratio, were then deducted. The railroad in question accepted the gross revenues determined upon such mileage ratio but claimed that the gross expenses determined by such ratio were substantially less than the expenses of the North Carolina mileage. As to whether the expenses of the North Carolina mileage were more or less than those as determined by the statutory formula this Court said (297 U. S. at page 686) that there was evidence in the record giving support to the company's position and that up to that point the company took upon itself the burden of making out a case for the rejection of the formula. This Court then said, however (p. 686):

> "There, however, it stopped, declining to go further. From the testimony of its witnesses we learn that actual expenses were greater in North Carolina than the average expenses apportioned to that state on the basis of the ratio between state and system mileage. We learn nothing from the witnesses as to the ratio between revenues, average and actual. For all that appears in the case developed by the Railway actual gross revenues in North Carolina may have been so far in excess of average gross revenues computed under the statute as to neutralize the discrepancy between actual and average costs of operation. If such a counterbalance exists, appellant has not been injured through the application of the formula."

It then appeared that the state itself had offered evidence that through the application of the formula the gross revenues of the North Carolina mileage were underestimated to a greater extent than the operating expenses. On this branch of the case the company's witnesses claimed that there was no method of allocating revenues with any greater approach to certainty than by means of the mileage ratio. As to that testimony this Court said that either for that reason or some other the witnesses had not made an attempt to ascertain receipts, no matter how approxi-

mately, by any other method as assuredly they would have tried to do if the statutory formula had been abolished altogether. The trial court found that from the evidence the actual gross operating revenues if determined otherwise than by the formula "would be increased by a much greater proportion than the operating expenses in North Carolina are increased over the operating expenses determined by the use of the statutory formula." That finding was approved by the Carolina Supreme Court. This Court then went on to say that the taxpayer attacking the formula could not attack the prorating on the expense side and offer no evidence as to the revenue side, and that the evidence

> "to be effective must be directed to each of them alike, for only thus can the assumed relation between them be proved to be unreal. This taxpayer disclaims the duty and even the endeavor to respond to such a test. It varies the numerator of the fraction while accepting the denominator."

Had Appellant in this case applied an allocation formula to its total expenses at all houses, and at the same time insisted upon using as the gross revenue of the San Francisco house only the actual receipts from sales made at that house,[1] or conversely if it had applied an allocation formula to its total sales or gross receipts and then used the actual expenses of the San Francisco house in determining its California income, a question would have been presented quite different from that presented by the present record. In the instant case both gross revenue and expense have been determined by the actualities of the operations of the San Francisco house, excepting only to the extent of the necessity of allocating to the San Francisco house as additional expense a reasonable proportion of the common expenses. While perhaps such common expenses could have been allocated upon some basis other than that actually employed, nevertheless there is no issue between the parties in that regard in view of the stipulation:

"That the accuracy and propriety of the basis of

allocation of such common expenses for the year 1935 are admitted." (Stipulation of Facts, par. 4; R. p. 9.)

It is further to be noted that a simple arithmetical computation discloses that in view of the total sales of the San Francisco house amounting to $5,206,000 (R. p. 10) and the operating loss of $82,851, the total operating costs must have amounted to $5,288,851, of which the allocated common expense amounted only to $100,091—less than 2 per cent of the total operating expense of the San Francisco house..

It was also stipulated that of the allocated common expense amounting to $100,091, 75 per cent would have been incurred even had the San Francisco house not been operated. (R. p. 9.) Were this 75 per cent, or $75,000, eliminated from the San Francisco account entirely Appellant would still have incurred a loss at that house. Only by eliminating all of the allocated common expense would a "net income" result—and then only in the amount of $18,000, the difference between the $82,851 of loss as shown and the amount of the allocated common expense of $100,091. However, as we see it, to eliminate from the San Francisco accounts any part of the overhead or other common expense would be not only to distort the income of that house, but also to distort the income of the other houses inasmuch as the other houses would have to absorb the whole of such expense.

Under the facts of this case the *Norfolk & Western* case does not support Appellee's position, or the decision of the court below. Certainly what this Court had to say in that case about a partial use of a statutory apportionment method in determining the income to be taxed by the taxing state has no relevancy to the instant case.

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1. As the company apparently tried to do in *North American Cement Company* v. *Graves*, 299 U. S. 517.

VI.

The Court Below Was in Error in Deciding This Case by Indulging in Inferences and Presumptions Contrary to the Provisions of Paragraph 12 of the Stipulation of Facts Upon Which This Case Was Tried.

We have assigned error in the above regard. (R. pp. 43; 48.)

We refer, in this connection, to such statements in the opinion of the court below as the following:

> "If the omission of the California sales would have no effect on the purchasing power, the omission of sales in an equal amount wherever made would likewise have no effect on the company's ability to purchase at a saving. Thus, by proceeding in turn from state to state, it could be shown that *none of the sales in any of the states* should be credited with the income resulting from the purchasing of goods in large quantities." (Italics ours.) (R. p. 29.)

> "The former [the central advertising division] enables appellant to spread its advertising cost over more stores and units and to secure its advertising at a lower cost per unit, thereby making possible advertising opportunities unavailable to a single store; as to the latter (central accounting and management department), the volume of business resulting from operation of the company's several stores permits better as well as more costly services of accounting and management to be available to each store, whereas if each were separately operated, services of such quality in all probability would be too expensive to be practicable." (R. p. 29.)

> "In the case at bar appellant has not furnished any explanation of why its California business differs so from the average that the formula produced an erroneous result." (R. p. 37.)

> "*As appellant has failed to show a variance from normal in either the California sales, property or pay-*

roll, or in either expenses or revenue, it is our conclusion that appellant has not upheld its burden of proof. * * *" (R. p. 37.)

All of these are matters wholly outside of the Stipulation of Facts, and amount to mere speculation and conjecture on the part of the court in direct violation of paragraph 12 of the Stipulation of Facts.

In the Petition for Rehearing (R. pp. 38-40) we called the Court's attention to these conjectural matters. As to the first statement above quoted, perhaps the court merely meant that the elimination of sales at any house equal to those at the San Francisco house would not affect the company's aggregate buying power. But even this would be problematical. Suppose that some other of appellant's several houses, say the Chicago house, had total sales of $15,000,000. Then suppose further that $5,000,000 of these sales were eliminated. What the result would be if carried to a normal and logical conclusion is purely conjectural. If such an event were to take place, the Chicago house might not be able even to operate, thereby eliminating—through cause and effect—the whole of the $15,000,000. So far as anything appearing in the stipulation in this case is concerned such elimination would most certainly affect the company's aggregate buying power. The statement of the California Supreme Court therefore in this light must be considered purely as an abstraction and meaningless.

As a matter of fact, however, we are inclined to doubt if the California court intended such a limited meaning to its statement. The following sentence is that by proceeding in turn from state to state it could be shown that "none of the sales" in any of the states should be credited with the income resulting from the purchasing of goods in large quantities. We would understand the court to mean by this statement that the elimination of the whole of the sales at some one or another of the other houses would have no effect upon the company's aggregate buying power.

There is nothing in this record to support such a violent assumption or conjecture. The effect of the elimination or addition of amounts equal to the purchases made for the account of the San Francisco house was the subject matter of paragraph 9 of the Stipulation of Facts. (R. pp. 10-11.) There was no equivalent stipulation as to the effect of the elimination or addition of amounts equal to the purchases made for the account of any of Appellant's other houses. Whatever such effect might be is not the proper subject matter of conjecture in deciding this case.

As to the second statement above quoted, there is nothing whatsoever in the stipulation as to what constitutes the so-called "central advertising division" mentioned in paragraph 4 of the stipulation and the expense of which constituted a part of the common expense. (R. p. 9.) In Appellant's Petition for Rehearing in the court below, to which we have referred, Appellant offered to show by evidence that the

> "so-called advertising of the company consists wholly in the preparation of catalogs and their distribution to retailers with whom the company does, or seeks to do, business, and that no advertising advantages other than certain economies of preparation exist by reason of the presence of the seven houses."

Likewise there is no such term used any where in the stipulation as "central accounting and management division"—although we can only assume that the court has in mind the statement in paragraph 4 of the stipulation that there are included in the allocated common expenses "executive salaries" and "certain accounting expenses." The court's statement, therefore, as to the economies of what it terms the "costly services of accounting and management" are wholly speculative and conjectural.

As to the last statement above quoted, we have already taken occasion to say that the court below, as does Appellee, seems in this indirect fashion to challenge the cor-

rectness of the *stipulated* facts as to the California loss. As has just been stated, the reason for there being a loss in California is of no relevancy as against the controlling factor that a loss did in fact result as shown by the stipulation. In Appellant's petition for rehearing in the court below Appellant as to this point offered to produce evidence as to why the San Francisco house operated at a loss. (R. p. 42.) We point out, however, both as to this point and as to the nature of the so-called "central advertising division" Appellant has the right to produce the evidence itself—if such evidence is to be deemed material—and should not be required to present it to the court in any such summary manner.

Appellee seems to say that the ultimate conclusion from the facts stipulated as to the results of the Appellant's operations in California would itself be barred if our objection were good, and that therefore Appellant has stipulated itself out of court. The answer to this argument would seem rather obvious. In the first place, Appellee is incorrect in saying that in such a case the California court would be guilty of a mere error which would not give this Court jurisdiction. When a reviewing court decides a case by indulging in inferences and presumptions and in speculation and conjecture contrary to the agreement and stipulation of the parties upon which the case was tried, which in terms precludes any decision from being made based upon any such inferences and presumptions or speculations or conjectures (Stipulation of Facts, par. 12) and resolves all of such inferences, presumptions, speculations and conjectures adversely to Appellant instead of remanding the case for the taking of further evidence to supply the deficiencies as said paragraph 12 of the Stipulation of Facts contemplated, appellant has in effect been denied an opportunity to be heard upon matters which, at least to the mind of the California court, were material facts. Such a situation is clearly within the principles announced in

Saunders v. *Shaw*, 244 U. S. 317. Appellant certainly had no reason to anticipate that the California Supreme Court would find it necessary to, and would actually depart, from the stipulation of the parties in deciding this case adversely to appellant—certainly when the California Appellate Court in its opinion and judgment had held the assessment void. (R. p. 16.) And this action having been done by the California Supreme Court in its opinion in this case, Appellant's first opportunity of objecting to such procedure was through its petition for rehearing herein. Where there is such a denial of an opportunity to be heard Appellant's constitutional rights have been infringed and the objection can be taken for the first time on the petition for hehearing. *Saunders* v. *Shaw, supra; Ex rel. Missouri Insurance Co.* v. *Gehner*, 281 U. S. 313; *Brinkerhoff-Faris Co.* v. *Hill*, 281 U. S. 673. See also *American Surety Co.* v. *Baldwin*, 287 U. S. 156; *Great Northern Ry. Co.* v. *Sunburst Oil & Refining Co.*, 287 U. S. 358.

The further answer is that Appellant's challenge was not directed to the Court's making the ultimate factual conclusion from the facts which were stipulated, but it was directed to such inferences and presumptions as the court indulged in when it questioned the stipulated facts and questioned whether or not a loss ever occurred and speculated as to the advertising division, and executive salaries and accounting expenses. Finally we point out that even if Appellee were correct and the court below was precluded from making the ultimate conclusion from the stipulated facts that a loss resulted in California, paragraph 12 of the Stipulation would still operate and the case would have to be returned to the trial court for the taking of further proofs as the Stipulation in terms provides.

Appellee claims that the purpose of the Stipulation

> "was to overcome the presumption of official regularity and not to shift the burden of proof from plaintiff to defendant or to remove the burden of proof from both parties."

We are not clear as to just what appellee means by such statement. Nevertheless nothing in the Stipulation suggests that paragraph 12 had any such limited or restricted meaning or effect. The obvious purpose of a stipulation of facts is to obviate the time and expense of taking evidence as to factual matters which are agreed upon by the parties. It was supposed by both parties that the facts stipulated were sufficient to permit of a decision of this case upon the merits. The purpose of the stipulation was to preclude any decision adverse to either Appellant or Appellee in the possible event that the facts as stipulated were insufficient to permit of a decision being made. This can only be the meaning of paragraph 12 in providing that if

> "this stipulation fails to establish any fact necessary to a decision, the case shall be reopened for the taking of further proofs with respect thereof." (Stipulation of Facts, paragraph 12; R. p. 11.)

The stipulation, and paragraph 12 thereof, do not bar the Court from declining to decide a question of importance like that involved in the instant case if the facts presented are adequate for that purpose—or even if the Court thinks that the facts presented are inadequate. In fact paragraph 12 contemplated the possibility that the Court might take that view of the matter. At the same time with such contingency in mind the stipulation was intended to safegard the rights of both Appellant and Appellee and to insure their right to present evidence as to any matters which were, or which in the opinion of the California courts were, insufficiently or inadequately covered by the stipulation. It was never intended to permit the Court—if the stipulated facts were inadequate to permit of a decision on the merits—to indulge in speculation and conjecture as to factual matters outside of the stipulation and decide all of them adversely to Appellant. Had the court below indulged in such speculation and conjecture as to factual matters adversely to Appellee we are quite sure he would have promptly and vigorously objected—as he

properly should do. And the situation resulting from this course of action on the part of the court below is made more acute because of the fact, as we view it, that the matters thus made the subject matter of speculation and conjecture are wholly irrelevant and immaterial so far as the controlling issues in this case are concerned. Appellant insists that the stipulated facts are fully adequate without additions thereto by the Court in the way of inference or presumption to decide the Federal question presented, and that the facts as stipulated require a decision in Appellant's favor if the case is to be decided consistently with the principles announced in the *Rees* case.

And if in the face of paragraph 12 of the Stipulation the stipulated facts themselves are deemed insufficient to permit of a decision of this case, and if thereupon the case is to be decided adverse to Appellant contrary to such stipulation, Appellant certainly has been denied the requisite opportunity to be heard as to the validity of the tax in question.

Conclusion.

We do not understand that this Court regards the *Rees* case as overruled or shaken in any way by any of its later decisions. As we understand it, in the *North American Cement* case the State accepted the *Rees* case without question, and argued the case upon the ground that it came within the principles of the *Underwood* and *Bass* cases rather than the *Rees* case. The *per curiam* decision indicates such to be the case. Under the *Rees* case, the judgment below, we insist, must be reversed.

Respectfully submitted,

Leland K. Neeves,
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APPENDIX.

AN ACT TO CARRY INTO EFFECT THE PROVISIONS OF SECTIONS 14 AND 16 OF ARTICLE XIII OF THE CONSTITUTION OF THE STATE OF CALIFORNIA RELATING TO BANK AND CORPORATION TAXES, APPROVED MARCH 1, 1929, STATS. 1929, P. 19.

"4. *Financial corporation to pay tax.* • • •

(3) *Corporations other than financial doing business in this State to pay tax. Minimum tax.* With the exception of financial corporations, every corporation doing business within the limits of this State and not expressly exempted from taxation of the provisions of the Constitution of this State or by this act, shall annually pay to the State, for the privilege of exercising its corporate franchises within this State, a tax according to or measured by its net income, to be computed, in the manner hereinafter provided, at the rate of four per centum upon the basis of its net income for the next preceding fiscal or calendar year. In any event, each such corporation shall pay annually to the State, for the said privilege, a minimum tax of twenty-five dollars.

• • • • •

6. *The term 'gross income'*, as herein used, includes gains, profits and income derived, from the business, of whatever kind and in whatever form paid; gains, profits or income from dealings in real or personal property; • • •

8. *Deductions allowed.* In computing 'net income' the following deductions shall be allowed:

(a) *Expenses.* • • •
(b) *Interest.* • • •
(c) *Taxes or licenses.* • • •
(d) *Uncompensated losses.* • • •
(e) *Bad debts.* • • •
(f) *Depreciation.* • • •
(g) *Depletion.* • • •

• • • • •

10. *Computation of tax on intrastate business.* If the entire business of the bank or corporation is done within this State, the tax shall be according to or measured by its entire

net income; and if the entire business of such bank or corporation is not done within this State, the tax shall be according to or measured by that portion thereof which is derived from business done within this State. The portion of net income derived from business done within this State, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, pay roll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation.

If the commissioner reallocates net income upon his examination of any return, he shall, upon the written request of the taxpayer, disclose to him the basis upon which his reallocation has been made.

12. *Computation of net income.* The net income shall be computed upon the basis of the taxpayer's annual accounting period, fiscal year or calendar year as the case may be, in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of said commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year, or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

* * * * *

13. *Returns.* (a) Every bank and corporation shall, within two months and fifteen days after the close of its income year, transmit to the commissioner a return in a form prescribed by him, specifying, for the income year, all such facts as he may by rule, or otherwise, require in order to carry out the provisions of this act.

* * * * *

15. *Form of returns.* Every return required by this act to be filed with said commissioner shall be verified by an executive officer of the bank or corporation. Blank forms of return shall be furnished by said commissioner on appli-

cation, but failure to secure such a form shall not release any taxpayer from the obligation of making a return hereunder.

• • • • •

18. *Penalties for failing to file, or filing false returns.* Any bank or corporation failing or refusing to furnish any return hereby required to be made or failing or refusing to furnish a supplemental return or other data required by the commissioner, or rendering a false or fraudulent return, shall be guilty of a misdemeanor and subject to a fine of not exceeding five thousand dollars ($5,00) for each such offense.

• • • • •

24. *Interest on unpaid taxes.* (a) Interest upon the amount determined as a deficiency under the provisions of section 25 of this act shall be assessed at the same time as the deficiency, shall be paid upon notice and demand from the commissioner, and shall be collected as a part of the tax, at the rate of six per centum per annum from the date prescribed for the payment of the tax (or, if the tax is paid in installments, from the date prescribed for the payment of the first installment) to the date the deficiency is assessed.

• • • • •

25. *Examination of returns. Notice of additional tax.* As soon as practicable after the return is filed, the Commissioner shall examine it and shall determine the correct amount of the tax. If the commissioner determines that the tax disclosed by the original return is less than the tax disclosed by his examination he shall mail notice to the taxpayer at its post-office address (which must appear on its return) of the additional tax proposed to be assessed against it. Such notice shall set forth the details of the proposed additional assessment and of computing said tax.

Protest. Within sixty days after the mailing of said notice the taxpayer may file with the commissioner a written protest against the levy of the proposed additional tax, as computed by the commissioner, specifying therein the grounds upon which the protest is based: The protest must be under oath."

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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1941.

No. 283

BUTLER BROTHERS, A CORPORATION,
Appellant,

vs.

CHARLES J. McCOLGAN, AS FRANCHISE TAX COMMISSIONER OF THE STATE OF CALIFORNIA,
Appellee.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA.

APPELLANT'S REPLY BRIEF.

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Of Counsel.

THE GUNTHORP-WARREN PRINTING COMPANY, 310 WEST JACKSON, CHICAGO

IN THE

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vs.

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Appellee.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA.

APPELLANT'S REPLY BRIEF.

MAY IT PLEASE THE COURT:

Any detailed reply to Appellant's brief seems to us unnecessary. As a matter of fact Appellee's argument is in substance anticipated and answered in Appellant's original brief.

The Facts.

Appellee challenges certain statements as to factual matters which appear in Appellant's brief in the summary of the argument. See Appellee's brief, page 2.

We think the challenged statements are fairly supported by the stipulation. Paragraph 2 of the stipulation (R.

p. 8) states that stocks of goods are maintained at each of the company's houses "from which sales in the respective territories served by each house are made. Each house serves a separate trade territory, having its own sales force, and all sales made by the company in the State of California are made from the San Francisco house. * * * It is agreed that all receipts from sales made in California have been credited to the San Francisco house." There is nothing in this to suggest that the San Francisco house's trade territory is limited to the State of California, and does not embrace other states. Paragraph 8 of the stipulation (R. p. 10) states that in 1935 the total sales made by the company at all houses amounted to $66,326,000, "of which $5,206,000 were made from the San Francisco house." Paragraph 1 of the stipulation (R. p. 8) states that the company maintains and operates "wholesale distributing houses at Chicago, Illinois; Minneapolis, Minnesota; St. Louis, Missouri; Jersey City, New Jersey; Baltimore, Maryland; Dallas, Texas; and San Francisco, California.

Appellant's statements which are challenged by Appellee were prompted by the fact that in the opinion of the court below it is said that a percentage formula of allocation was approved by the California court in *Matson Navigation Co.* v. *State Board*, 3 Ca. (2d) 1, 43 Pac. (2d) 805, and inferentially approved by this Court when the *Matson* case was affirmed. *Matson Navigation Co.* v. *State Board*, 297 U. S. 441. In our original brief, at page 47, we pointed out that there was no question whatsoever in that case as to apportionment, and that the only question was as to whether the percentage formula of allocation there applied was to be applied to a base which included receipts from interstate and foreign commerce, and that this Court in its opinion in that case stated that "no question of apportionment" was there involved. (See Appellant's brief, p. 48.) At no time has it been claimed by

Appellee that so far as the San Francisco house is concerned Appellant has not accounted with respect to receipts derived from sales in interstate commerce, that is, sales involving shipments from the warehouse at San Francisco to customers in other states. And there has been no issue at any time between Appellant and Appellee with respect to any such question. As a matter of fact, we note that the *Matson* case is not even mentioned in Appellee's brief, nor is any claim made in his brief that receipts of the San Francisco house derived from sales in interstate commerce have been omitted. We would assume that Appellee will concede this to be the fact, when the case is orally argued. Under the circumstances, therefore, it would seem that Appellee's criticism is inconsequential.

Appellee also questions our statement (Appellant's Brief, p. 15) that Appellant's net income was $1,149,677 after taking into consideration the loss at San Francisco of $82,851. It is said (Appellee's Brief, p. 2) that such statement is not found in the record. Again we think the statement is fairly supported by the stipulation. Paragraph 7 of the stipulation (R. p. 10) states that in 1935 "the operations of all houses of the company produced a profit of $1,149,677" and that the state's percentage formula was applied to that figure. Paragraphs 2 to 5, both inclusive, state how the operations are carried on and how the accounts of the company are kept at its several houses. The accounts of the company in the light of the company's operations as they are actually conducted show a loss at the San Francisco house of $82,851. If the total result of all the company's operations is $1,149,677, such figure necessarily reflects the loss at San Francisco. And there is no contention, as we understand it, that Appellant's total net income exceeds $1,149,677.

But again without regard to the literal accuracy of Appellant's statements, we respectfully submit that the stipulation of facts is adequate to bring this case within

the rule of the *Rees* case and to require a reversal of the judgment of the California Supreme Court.

The Law.

Appellee, by an extremely tortuous process of argument (Appellee's Brief, pp. 7-24) which we find difficult to follow, contends that in the case of a unitary business a percentage formula method of allocation is *necessarily* valid and must *necessarily* be sustained. And on page 23 of his brief Appellee learnedly argues the case of the two horses—a situation far removed from the instant case. That Appellee's contention is as stated above conclusively appears when he concludes (Appellee's Brief, p. 24) that "the separate accounting method is wholly unsuited to the proper apportionment of the income of a unitary business," and that "it is believed that the only proper method for making the apportionment is to employ a formula which gives weight to the various factors responsible for the earning of income," etc. And see Appellee's Brief at pp. 40-43.

It is also obvious that in the light of the stipulated facts Appellee is forced to take this extreme position, viz., that without regard to the factual situation a percentage formula of allocation is valid. And we believe it is fairly to be said that the essence of Appellee's case is that the *Rees* case, applying the principle recognized in the *Underwood* and *Bass* cases, was wrongly decided and should be overruled, and that the principle itself recognized by this Court in all the cases, and repeatedly applied (See Appellant's Brief, p. 39, *et seq.*) is unsound. Appellee's contention is itself unsound, and not only is without support in the decisions of this Court, but is opposed by the very cases upon which he chiefly relies.[1] And in the *Rees* case the court

1. *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113; *Bass, Ratcliff & Gretton* v. *State Tax Commission*, 266 U. S. 271; *North American Cement Corporation* v. *Graves*, 299 U. S. 517.

applied the principle which it had recognized in the *Underwood* and *Bass* cases when it said (283 U. S. at page 132):

> "Evidence which was found to be lacking in the *Underwood* and *Bass* cases is present here. These decisions are not authority for the conclusion that where a corporation manufactures in one state and sells in another the net profits of the entire transaction as a unitary enterprise may be attributed, regardless of evidence, to another state."

And further:

> "But the fact that the corporate enterprise is a unitary one in the sense that the ultimate gain is derived from the entire business does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one state regardless of the extent of which it may be derived from the conduct of the enterprise in another state."

In the *Bass* case the court considered the business, in so many words, as a unitary business (266 U. S. at page 282). Nevertheless the decision turned not upon that fact but upon the fact that as in the *Underwood* case it was not shown that the

> "application of the statutory method of apportionment has produced an unreasonable result."

And likewise the decision in the *North American* case turned not upon the nature of the business as being unitary, but upon the fact that it [the formula]

> "has not been shown to have been so applied as to violate Appellant's constitutional rights"—citing in that connection the *Bass* case.

At page 26 of his brief Appellee persists in arguing that Appellant's business is a unitary business. In that connection Appellee apparently makes a distinction between the effect of the language used in paragraph 9 of the stipulation that the addition of purchases or the reduction in the volume of purchases "in an amount equal" to those made for the San Francisco house would not affect

Appellant's aggregate purchasing power, and the effect had the language omitted the words above quoted. This seems to us to be largely a quibble. As a matter of fact, the words quoted were omitted by the California appellate court in its first opinion, and Appellee's petition for rehearing sought to capitalize thereon. That court said, however, in denying the rehearing, that no point was made by Appellee arising out of the omission of the words mentioned, and that the words had appeared in the statement of facts in the opinion. And further, that Appellee was claiming that the court had failed to note that part of the stipulation, but that such facts have not been omitted and that "they may state a general law of economics but as the parties had definitely stipulated with reference to the operations of the San Francisco branch the latter facts must control as applying to this specific instance." (Underscoring by the court.)

Appellee's real objection seems to be that in some way the provisions of paragraph 9 of the stipulation should be disregarded and that in some way the controlling factor is the statement appearing in paragraph 8 of the stipulation (R. p. 10) that "by reason of the volume of purchases made by the company more favorable prices are obtained than would be obtainable with respect to purchases for the account of any individual house operated by the company."

But even so, inasmuch as it appears that the San Francisco house has been charged for the merchandise purchased for its account only the actual cost thereof based upon the company's aggregate purchasing power, we fail to see how that house has been prejudiced or how any greater benefit can be credited to it because of Appellant's aggregate purchasing power, or "purchasing differential" as it is termed by Appellee. Appellee's argument based upon the two horses indicates his view that the San Francisco house was to be charged for its merchandise purchases at something less than the actual cost thereof. It seems to us that Appellee's argument with respect to the

metal blocks (Appellee's Brief, pp. 28-29) is of the same caliber as his argument with respect to the two horses.

As to Appellee's argument commencing on page 31 under his heading "C" the same is answered in detail in our original brief. In our comments with respect to the *North American Cement* case we referred (Appellant's Brief, p. 35) to the accounts which were sought to be used before the New York State Tax Commission, and said we assumed that those accounts would be set forth in Appellee's brief in this Court. We find that the statements have been so included in the appendix to Appellee's brief commencing at page 49.

Under his heading "D" (Appellee's Brief, p. 38) it is insisted that the stipulation in the instant case comes within the condemnation of this Court as expressed in *Norfolk & Western Ry. Co.* v. *Maxwell*, 297 U. S. 682. That case was discussed at some length in our original brief commencing at page 65. Appellee states nothing in his argument with respect to that case which was not anticipated in our original brief.

Under his heading "E" Appellee renews his contention that a percentage formula of allocating income is the only possible method to be employed. The arguments advanced are those heretofore advanced in this Court, but without avail where the factual showing demonstrates that the percentage formula method of allocation works out unreasonably or arbitrarily. We are confident that this Court will hold that where the operations in the taxing jurisdiction—here California—have been conducted at an actual loss amounting to $82,851 a percentage formula of allocation is in point of law unreasonable and arbitrary when it converts such a loss into a supposed taxable gain of $93,551.50—a difference of $175,000. Consistently with the *Rees* case, the State of California may not, by applying a mere formula, create $175,000 of income out of nothing, or appropriate that much income from some other taxing

jurisdiction in order to produce revenue for itself. In either event the operation and application of the statutory allocation formula is unreasonable, arbitrary, and confiscatory. And the resulting tax is invalid within the principle of the *Rees* case.

At page 43 of his brief Appellee endeavors to sustain the action of the California Supreme Court in indulging in inferences and presumptions adverse to Appellant, and deciding the case accordingly. Without unduly stressing this aspect of the case, the effect of paragraph 12 is not, as Appellee seems to contend, to permit the court, if it deems the stipulation inadequate to establish a fact necessary to the decision, to speculate as to the fact and determine the case in the light of its own conjectures and speculation. Rather it is to require, as the stipulation in terms provides shall be done, namely, the reopening of the case for further proof.

The situation thus presented, and what the court below has done, is not merely to apply a local rule of practice (Appellee's Brief, p. 44), but it is in effect to deny Appellant an opportunity to be heard.

We respectfully urge again that the judgment of the court below cannot be sustained consistently with the *Rees* case. We further submit that the stipulated facts, without more, show the case to be one where the percentage method of allocation for tax purposes results unreasonably and arbitrarily.

We therefore ask that the judgment appealed from be reversed with instructions that judgment be entered for Appellant.

Respectfully submitted,

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BROBECK, PHLEGER & HARRISON,
Of Counsel.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 283

BUTLER BROTHERS,

Appellant,

vs.

CHARLES J. McCOLGAN, AS FRANCHISE TAX COMMISSIONER OF THE STATE OF CALIFORNIA.

APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA.

STATEMENT OPPOSING JURISDICTION AND MOTION TO DISMISS OR AFFIRM.

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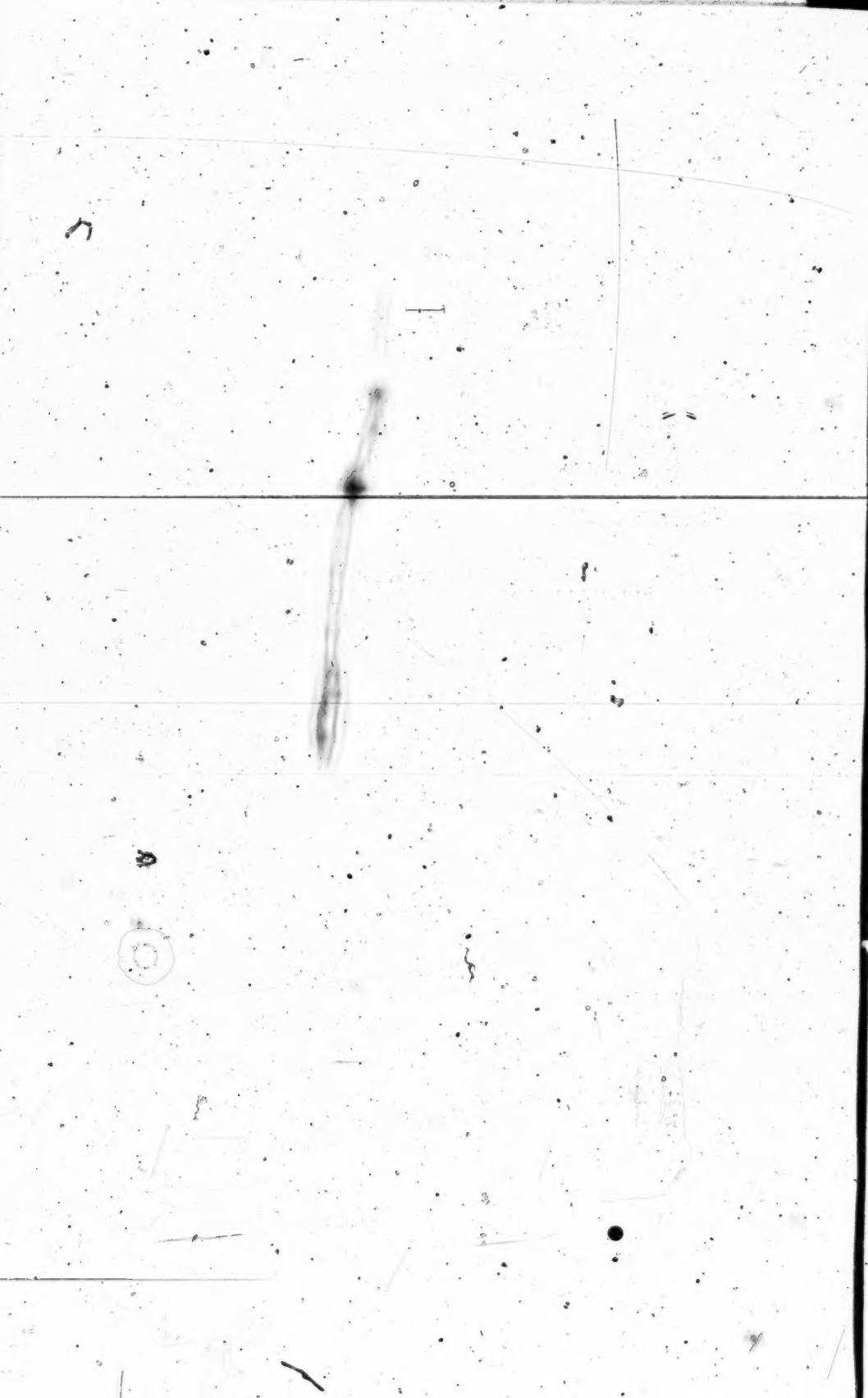

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 283

BUTLER BROTHERS, A CORPORATION,

Appellant,

vs.

CHARLES J. McCOLGAN, AS FRANCHISE TAX COMMISSIONER OF THE STATE OF CALIFORNIA,

Appellee.

MOTION TO DISMISS OR AFFIRM AND STATEMENT OPPOSING JURISDICTION.

May it please the Court:

Appellee in the above entitled cause moves the court to dismiss this appeal or to affirm the judgment below for the following reason:

1. There is no substantial Federal question presented as a basis of jurisdiction in this Court, because the questions presented have been so thoroughly foreclosed by previous decisions of this Court as to leave no debatable ground for attacking the decision of the Supreme Court of California, and therefore the questions presented are unsubstantial.

Wherefore, appellee moves the Court to dismiss the appeal in this cause for lack of a substantial Federal question.

or, in the alternative, to affirm the judgment of the Supreme Court of California from which this appeal was taken, for the reason that the questions presented are foreclosed by prior decisions of this Court.

ARGUMENT IN SUPPORT OF MOTION.

Statement of the Case, Including the Facts.

This cause involves the validity of a tax collected by appellee from appellant pursuant to provisions of the Bank and Corporation Franchise Tax Act of California, which imposes on corporations doing business in California a franchise tax measured by net income. (*Cf. Pacific Co.* v. *Johnson*, 285 U. S. 480, affirming 212 Cal. 148, 298 Pac. 489, and *Matson Navigation Co.* v. *State Board of Equalization*, 297 U. S. 441, affirming 3 Cal. (2d) 1, 43 Pac. (2d) 805). The appellant claimed that its operations in California in the year 1935 resulted in a net loss, whereas the appellee applied a formula to appellant's entire net income and allocated to California a portion of that income. The appellant paid the tax so computed and sued to recover it. The California Supreme Court affirmed the judgment of the superior court, thus denying appellant the recovery sought and upholding the allocation made by appellee.

The facts are stipulated and show that appellant is an Illinois corporation which operates seven wholesale stores, one of which is in California. The goods sold in all of appellant's wholesale houses are purchased by it through its central purchasing division. Appellant also has a central advertising division, a central accounting division and central executives. These central divisions are located in Illinois. By reason of the volume of appellant's sales it is able to buy in great volume, thus purchasing at lower prices than if it operated only one store. According to books of account kept at the California house, appellant's California

operations were conducted at a net loss, although appellant's business throughout the United States, of which the California business was a part, was conducted at a profit of $1,149,677.

Appellant's California books are kept by a recognized separate accounting method, which is more fully described in the stipulation of facts. The appellee refused to agree that the California business was actually operated at a loss and determined the net income attributable to California by an allocation based on a three-factor formula of property, payroll and sales. By this formula 8.1372% of appellant's entire net income was allocated to California, which percentage was computed by averaging the percentages which the California tangible property, payroll and sales bore to appellant's total tangible property, payroll and sales. Appellant stipulated that this formula is proper if any formula is.

Cases Believed to Have Foreclosed the Questions Presented, Thus Rendering Them Unsubstantial.

The Supreme Court of California held that appellant's business was a unitary business, i. e., one which operates in several States as one unit so that the division of the business into several geographical units separated by State lines would be artificial, not real. That court based this conclusion on the fact that the California store contributed to the sales volume which enabled appellant to purchase at more favorable prices than it otherwise could have done. Reliance was also placed on the California store's contributing to the maintenance of appellant's central advertising division, central accounting division, and central executives. From this conclusion the California court reached the further conclusion that the California store necessarily contributed something to appellant's business throughout the

United States, and was a component factor in producing appellant's net income of $1,149,677.

The conclusion of the California court that appellant's business is unitary in character is fully supported by the decision of this Court in *Great Atlantic & Pacific Tea Co.* v. *Grosjean*, 301 U. S. 412, where the Louisiana chain store tax was upheld notwithstanding that it was imposed at a graduated rate which varied with the total number of stores in the chain, including those in other States. This Court pointed out the advantages attendant on volume selling possessed by such chains, and held that those advantages need not be disregarded by the States in taxing such chains even though the volume selling was partly the result of sales by stores in other States. These advantages, which are obtained by operating several stores as a unit, also result in the earning of net income. Thus, while the decision did not involve the allocation of income, it was based on the same reason as the reason for treating a business as unitary.

The conclusion that appellant's business is unitary in character is also supported by *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113, and *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U. S. 271. Just as a corporation which manufactures goods for sale must sell them to derive income, so a corporation which buys goods for sale must sell them to derive income.

As appellant's business is unitary in character, a formula such as that herein may properly be used by California in allocating to California the portion of appellant's net income attributable to business done in California.

Underwood Typewriter Co. v. *Chamberlain*, 254 U. S. 113;

Bass, Ratcliff & Gretton, Ltd. v. *State Tax Commission*, 266 U. S. 271;

Norfolk & Western Ry. Co. v. *Maxwell*, 297 U. S. 682;
North American Cement Corp. v. *Graves*, 299 U. S. 517;
Cf. Hans Rees' Sons v. *North Carolina*, 283 U. S. 123.

These decisions likewise hold that the use of a formula not inherently arbitrary (and the formula herein is agreed to be proper if any formula can be) will be upheld as against constitutional objections where the formula is not shown to produce an unreasonable result.

The only evidence offered by appellant to prove that the formula in this case has produced an unreasonable result is its separate accounting, taken from the books of its California store. By this separate accounting appellant seeks to establish that its California operations resulted in a net loss instead of net income. Separate accounting cannot accurately reflect the source of income in the case of a unitary business and this Court has recognized that fact. In three cases already decided by this Court, allocation by separate accounting was offered to overthrow the results of formula allocation, and in each case this Court held that separate accounting was insufficient evidence. These cases:

Underwood Typewriter Co. v. *Chamberlain, supra*;
Bass, Ratcliffe & Gretton, Ltd. v. *State Tax Commission, supra*;
North America Cement Corporation v. *Graves, supra.*

The separate accounting in the *Underwood Typewriter* case, as disclosed by the record in that case, was strikingly similar to that offered here. The obvious fallacy of the allocation by separate accounting in that case well illustrates the impossibility of obtaining a correct allocation in the case of a unitary business by the use of separate accounting. In the *Bass Ale* case by the use of separate accounting the taxpayer offered proof that its American operations had resulted in a net loss. According to the

record in that case 93% of the taxpayer's business was conducted in New York, so if the evidence had been deemed creditable the inference would have been permissible that the New York business also resulted in a loss. Yet the New York formula, which allocated a portion of the taxpayer's entire net income to that State, was upheld. In the *North American Cement* case, the taxpayer complained of the New York formula and offered an elaborate separate accounting allocation, prepared and certified by a leading accounting firm, to prove that its actual net income from New York was less than that allocated to New York by the formula. The separate accounting in that case, as in the instant case, attributed a loss to the taxing State in some of the years involved. The evidence was held insufficient to overthrow the results of the formula allocation.

Furthermore, the separate accounting allocation offered by appellant allocates to California $75,000 of expenses which, it is stipulated, would have been incurred even if the California store had not operated. (Paragraph 4, Stipulation of Facts). While this is agreed to be in accordance with recognized accounting principles, it is impossible to reconcile with an attack on the formula theory of allocation. Manifestly it tends to produce a distorted result. Then, too, appellant, while attacking the use by appellee of a formula in allocating net income, allocates a portion of the expenses of maintaining its central divisions by a method which can only be some other formula. This Court has held that the formula method of allocation cannot be accepted in part and attacked in part.

Norfolk & Western Ry Co. v. *Maxwell*, 297 U. S. 682.

The decision in *Hans Rees Co.* v. *North Carolina*, 283 U. S. 123, does not cast doubt on the decision of the California Supreme Court. There the taxpayer offered an elaborate

analysis of its method of operation and of the factors creating its profits, which tended to show that a much smaller percentage of its net profits was allocable to North Carolina, where the major factory was located, than the 86% which the formula allocated to that State. The evidence tended to show that manufacturing was only slightly responsible for its profits, whereas the formula had the effect of attributing nearly the entire profits to one state of manufacture. This Court held that such evidence, treated as true, overthrew that particular formula, because it was proved that that formula attributed to North Carolina "a percentage of income out of all appropriate proportion to the business transacted * * * in that State." It is worthy of note that the formula herein is based on the percentage of business done in California, and not merely on property owned. Thus the income allocated to California was in exact ratio to the proportion of the business transacted in California. Appellant has not offered an analysis of the causes of its net income, but on the contrary has merely offered a different bookkeeping system which produces a result different from the result reached by appellee. Nothing has been offered to explain why appellant's method of operation should produce a loss in California while it was producing a large income from its total operations. The source of that large income has not been shown, whereas it was shown in the *Hans Rees* case, and the possibility certainly exists, unrefuted by the record, that separate accounting, used in turn to allocate the income of each of appellant's stores, would show a loss for each of them. Neither have business conditions been shown to exist which would cause a variation in California from the normal and hence cause a loss to be suffered in California while identical operations elsewhere produced a large income. With these

gaps in appellant's evidence, it cannot be said that appellant has proved oppression by clear and cogent evidence, which is appellant's burden. (*Norfolk & Western Ry. Co.* v. *Maxwell, supra*).

Possibly appellee may have misinterpreted *Bass, Ratcliff & Gretton Ltd.* v. *State Tax Commission, supra,* and *North American Cement Corporation* v. *Graves, supra,* by failing to interpret those cases as holding that a State franchise tax measured by net income may constitutionally be measured by a portion of the corporation's entire net income even though the operations in the taxing State for the previous year were conducted at a loss. There is an implication in the *Bass Ale* case that such is the view of this Court. If that be the case, those decisions support the decision below on that ground as well as on the ground previously discussed, for the tax herein involved, like the New York tax, is a franchise tax on the exercise of corporate franchises, measured by the preceding year's statutory net income, or an allocated portion of it.

The Asserted Disregard by the California Court of a Stipulation Regarding the Effect to be Given Inferences and Presumptions is Not a Ground for Reversal.

The sixth specification of error by appellant charges the California Supreme Court with reversible error for indulging in inferences and presumptions assertedly contrary to paragraph 12 of the stipulation of facts. Any oversight on the part of the California court regarding that stipulation would be mere error, which is not a denial of due process and does not give this Court jurisdiction.

Corrigan v. *Buckley*, 271 U. S. 323;
Worcester County Trust Co. v. *Riley*, 302 U. S. 292.

The construction which appellant seeks to place on paragraph 12 is unwarranted, and is also a two-edged sword. The stipulation reads insofar as important as follows:

> "It is agreed • • • that the Court • • • shall be bound by no inference or presumption in respect of any matter of fact not herein set forth • • •."

The purpose of this stipulation was to overcome the presumption of official regularity, and not to shift the burden of proof from plaintiff to defendant or to remove the burden of proof from both parties. Apparently appellant is preparing to argue that the case should have been decided without drawing any inference from the agreed facts or without insisting that one party bear the burden of proof. The stipulation is admittedly, on its face, susceptible to that interpretation, although that was not its purpose. If that is the interpretation then appellant has stipulated itself out of court, for the parties did not stipulate that appellant suffered a loss from its California business; they merely stipulated facts from which appellant asks this Court to draw such an inference.

Respectfully submitted,

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 283

BUTLER BROTHERS, a corporation,

Appellant,

vs.

CHARLES J. McCOLGAN, as Franchise Tax Commissioner of the State of California,

Appellee.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA

BRIEF OF APPELLEE

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The Opinion of the California Supreme Court is reported in 17 Cal. (2) 664, 111 Pac. (2) 334. The opinion of the California District Court of Appeal, which was vacated by the California Supreme Court, is reported in 102 Pac. (2) 776.

STATEMENT OF THE CASE

The statement of the case in appellant's brief, setting forth the stipulation of facts, is accurate and appellee accepts it, with exceptions discussed hereinafter which are necessary for emphasis of appellee's position rather than for correction of appellant's statement. The statement of facts appearing

in appellant's summary of argument is less accurate and we do not accept it. For instance, at the foot of page 13 appellant states that receipts from sales made by the San Francisco house in other states are credited to the San Francisco house's credit. The record does not support this statement; on the contrary the record does not suggest that the San Francisco house makes any sales in other States. Also, the statement in the first sentence of the first paragraph commencing on page 15 of appellant's brief, that appellant's entire net income was $1,149,677 "after taking into consideration the loss at San Francisco of $82,851" is not found in the record. The statement is appellant's creation, based on inferences drawn by appellant from the record and denied by appellee.

The stipulation of facts does not state that appellant operated at a loss in California, and appellee's contention is that the evidentiary facts stated in the stipulation do not establish that appellant did not derive the net income from California which the allocation formula attributed to California. The stipulation of facts further shows that appellant's business was a unitary business. (These statements are elaborated later, when the page numbers of the supporting part of the record will be given.)

Thus appellee contends that as appellant was conducting a unitary business within and without California, appellee was entitled to use a reasonable formula in allocating appellant's income. (The

formula used is specified to be a reasonable formula. Record, page 10, paragraph 7.) Appellee further contends that the formula method of allocation is best suited to produce a proper allocation of income, and that the allocation by separate accounting, which appellant offers as proof that the formula reached an unreasonable result, is itself not capable of producing a proper allocation and therefore is not an acceptable gauge to test the reasonableness of the formula allocation.

In other words, appellee contends that the Constitution of the United States does not compel him, as tax administrator, to accept appellant's separate accounting allocation as accurate and as conclusive evidence that the formula allocation has produced an unconstitutional result.

SUMMARY OF ARGUMENT

Appellee will show that the method of allocation offered by appellant as evidence that the use of the formula reached an unconstitutional result is itself incapable of reaching a correct result, and therefore is not evidence which is entitled to credence. We will also show its similarity to methods of allocation which other taxpayers have unsuccessfully offered to this Court as evidence that they have been subjected to unconstitutional exactions. We will show that the formula method of allocation is best suited properly to allocate the income of a unitary business, such as appellant's, and that it reaches

a more accurate result than the separate accounting method used by appellant. We also will show that the formula method is the only practicable method of allocation for the States to use in the case of a unitary business.

As appellant has attempted to construe the stipulation of facts as entitling appellant to as many new trials as may be necessary for appellant to prevail, and as prohibiting the drawing of any inferences unfavorable to appellant, we will also show that appellant's construction of the stipulation is insupportable.

THE STIPULATION OF FACTS

Because we believe that appellant is seeking to give an interpretation to the stipulation of facts, and particularly to certain portions of it, which differs from the intention of the parties, we believe it necessary that space be devoted to an analysis of the stipulation itself.

First, it should be observed that no express stipulation is made that the amount of local expenses was correctly shown in the local books, or even that the cost of the goods sold in California was correctly shown therein. Paragraphs 2 and 3 of the stipulation (Record, p. 8) state that entries for these charges were made in the local accounts, but no agreement is stated that these entries were correct. Paragraph 5 (R-9) states that these charges were deducted on appellant's books in the computation therein of the results of the California opera-

tions, but again there is no statement as to the accuracy of these entries. The inference may be drawn from paragraphs 10 (R-11) and 13 (R-12) that appellee merely disputes that separate accounting produces a correct allocation and that appellee does not dispute that the entries are correct if the basic assumption on which they are founded is correct; namely, that separate accounting allocation can be correct in the case of a unitary business. We have heretofore drawn this inference, and so did the California Supreme Court, for so the parties intended, but if appellant is correct that paragraph 12 (R-11, 12) of the stipulation prohibits the drawing of inferences, then we have improperly drawn this inference. In that event for all that the record shows the books may be hopelessly inaccurate on any theory and therefore appellant has not taken even the first step to prove its case.

Secondly, the stipulation does not state that appellant had a loss from its California business and appellee has throughout the case consistently denied that appellant did. The stipulated facts relate only to the manner in which appellant operated, what its local books showed, how the computation in those books was made, what appellant's entire net income was and how appellee's computation was made. To decide the case from those facts the California Supreme Court had to draw either of two inferences: (1) that there was a loss; (2) that

no loss was shown. Appellant has objected violently to the action of the California Supreme Court in drawing the latter inference, and has claimed that no inferences at all can be drawn in view of paragraph 12 of the stipulation, yet appellant's only hope of prevailing has been to persuade the courts to draw the former inference.

The foregoing discussion establishes either that appellant has stipulated itself out of court or that appellant's interpretation of the stipulation is insupportable. The latter alternative appeals to us. The sole purpose of the stipulation regarding inferences and presumptions was to avoid a decision resting entirely on presumption of official regularity. The stipulation was not intended to shift the burden of proof which appellant bore, as plaintiff, to appellee, the defendant. This, we submit, should be obvious. As plaintiff, appellant had to establish error in the use of the allocation formula. The issue in the case is whether this was established. The law of California is that it was not, and unless that law offends the Constitution appellant can not prevail.

Appellant has also objected to the action of the California court in stating that the central advertising division, central accounting and central executives indicate a unitary system. Appellant's objection is on the ground that the record does not specifically so state. However, the record does show that appellant itself considered that those

central divisions were made possible by the maintenance of the several stores and benefited them alike, for it allocated some of the expense of maintaining such divisions to each store, which appellee stipulated was correct. (R-9, para. 4) Thus the record supports the action of the California court.

Hereafter a section of our brief is devoted to a discussion of the second portion of paragraph 12 of the stipulation, agreeing to the reopening of the case for further facts if insufficient facts for a decision are contained in the stipulation. For that reason, no discussion of that portion of the stipulation is made at this point.

ARGUMENT

I. The tax on appellant has been measured by income derived from business done in California and not by income derived from business done in other States

A. In the case of a unitary business carried on within and without a State, the income derived from the business done in any State may more accurately be determined by an allocation formula than by separate accounting

There are in general two distinct methods, the separate accounting method and the formula method, commonly used for determining the income for income or franchise tax purposes from business carried on within a particular State, in the case of taxpayers engaged in business both within and without the State. Under the separate accounting

method, as the name implies, the business within the State is treated as though it were separate and distinct from the business carried on outside the State. An attempt is made to determine the net income from the particular State in the same manner that it would be if the business were confined to that State; an effort is made to determine the gross income from that State, and the expenses attributable to it are separately determined as closely as possible, and the latter figure is deducted from the former figure.

Where business is carried on both within and without the State, this method requires the segregation of the gross income and expenses attributable to the State from the total gross income and expenses. Where the business within the State is truly separate and distinct from the business without the State this segregation can be made fairly, easily and accurately, and, accordingly, the separate accounting method may properly be used. Where, however, the business within the State is not a separate business but is an integral part of a unitary business carried on within and without the State, difficulties will be encountered both in the segregation of the gross income attributable to the State and in the segregation of the expenses attributable thereto. Suppose, for example, that a particular company is engaged in the manufacture of goods in State A and the sale of such goods in State B. Goods costing $100,000 to manufacture

are sold for a total of $150,000. The company thus has a gross income, i.e., difference between cost and selling price, of $50,000. Before the net income from the business carried on in either State can be determined under the separate accounting method, it is necessary to determine what portion of the gross income is attributable to each State. One separate accounting method which taxpayers frequently contend should be used for making such apportionment is to determine a reasonable manufacturing profit which becomes the gross income for the State of manufacture and is added to the cost of the goods for the purpose of determining the gross income attributable to the State where the goods are sold. Thus, in the instant example, if a reasonable manufacturing profit were determined to be 10 per cent of the cost, the gross income attributable to State A would be $10,000. The cost of the goods manufactured and sold would be increased from the actual cost of $100,000 to $110,000 for the purpose of determining the gross income in State B, which as so determined would be $40,000.

The principal objection to the above method of apportioning the gross income is that any such determination of manufacturing profit is apt to be arbitrary, representing merely the opinion of the taxpayer, which may be biased, particularly if one State imposes an income tax or a tax measured by income and the other does not.

Any attempt to reach an objective standard for determining a reasonable manufacturing profit, based on the experience of other manufacturers, is not likely to prove successful. In the first place, it is probable that in the great majority of cases it will be impossible to find a sufficient number of manufacturers engaged in the production of the same goods, on the same scale and under similar conditions as in the case of the company in question, to be of any value for comparison purposes. But even if a sufficient number of such other manufacturers could be found, if they sell their goods in the same manner as the company in question, no assistance will be obtained from their experience since the identical problem of arriving at a manufacturing profit will exist in their case as well. Then too, if they sell their products in a different manner, at wholesale, for instance, whereas the company in question sells at retail, not only will there still be the problem of apportioning their income between manufacturing and selling activities for the purpose of arriving at a manufacturing profit but their experience will be of little help for comparison purposes. The most that their experience would tend to establish is what income the company in question might have made if it had sold its product in the same manner as such other manufacturers rather than in the manner in which it actually sold them. The problem, however, is to

determine how the income from a particular business conducted in a particular manner should be apportioned. A determination of this problem can not be made on the basis of conjecture as to what the results of operation would have been if the business had been operated differently.

Another method which taxpayers using the separate accounting method for allocating income of unitary businesses employ in segregating the gross income is to determine what the company in question would have paid for the goods it sold if it had bought the goods from independent manufacturers rather than manufactured them itself. This cost so determined is used in place of the actual cost, and the gross income is apportioned accordingly.[1] Thus, in the preceding example, it might be determined that the company would have had to pay $120,000 for the goods which it manufactured at a cost of $100,000 if it had not operated its own manufacturing plant, but instead had purchased the goods from other manufacturers. The gross income attributable to State A, the State of manufacture, would thus be fixed at $20,000. In arriving

[1] This was the method approved in *Standard Oil Co.* v. *Wis. Tax Comm.*, 197 Wis. 630, 223 N.W. 85, in which the Wisconsin court overlooked the fact that limiting the selling division's gross profit to the excess of the retail price over the wholesale price to independent purchasers had the effect of reducing the selling division's income in exact ratio to the increase in that division's effectiveness, for both the wholesale price and the fictitious market value are largely dependent on the effectiveness of the selling division. Other faults in the separate accounting approved in that case are that (1) it failed to allocate any gross income to Wisconsin from the maintenance there of tank farms for the storage of oil sold in other states but it did allocate to Wisconsin all of the expense of operating those farms, and (2) it allocated a portion of the central overhead expenses to Wisconsin but none of the central income.

at the gross income attributable to State B, $120,000 would be taken as the cost. Since the goods were sold for $150,000 the gross income attributable to State B would amount to $30,000. The theory underlying this method is that if the company had purchased its goods instead of manufacturing them itself, it would have had a gross income only in the amount of the difference between the purchase price and the sale price. Hence, under this theory, any additional gross income which it receives must be due to its manufacturing activity whereby it was enabled to save the difference between the actual cost of the goods and the price it would have had to pay if it had purchased such goods. The theory is fallacious. It is based on sheer conjecture as to what would have happened had the corporation confined its activities entirely to selling, which it did not do. One could as fairly indulge in conjecture as to the consequences if the corporation had not possessed its selling organization but had confined its activities entirely to manufacturing. In that case the corporation might not have been able to sell its goods at all, or at best might have been unable to sell them for more than the cost of manufacturing. That being possible, it must be that the entire net income is derived from or attributable to the selling activities. This conjecture is as reasonable as the one based on a supposed nonexistence of manufacturing activities, yet it reaches the opposite result. Both theories can-

not be right. Actually neither one is since each ignores the fact that the business is one unitary business consisting of two interdependent activities, both of which contributed to the earning of income.

Under any method of apportioning gross income, and as indicated above, such an apportionment is essential to the use of the separate accounting method, it may frequently happen that losses will be reported in some States whereas the company realizes net income from its entire business, and, in other cases, net income will be reported in some States whereas the entire business is operated at a loss.

Thus, suppose that in the preceding example the selling expenses amounted to $40,000. The company would accordingly realize a net income of $10,000 ($150,000 gross receipts less $100,000 cost of manufacture and $40,000 selling expenses). Under the separate accounting method, however, if the cost of the goods sold were assumed to be $120,000 for the purpose of apportioning gross income, the company would report a net income in State A of $20,000 ($120,000 minus $100,000, the actual cost of manufacture) and a loss in State B of $10,000 ($150,000 gross receipts minus $120,000, assumed cost=$30,000 gross income minus $40,000 selling expense=$10,000 loss). To show a loss in State B whereas without the activities therein the company might not have income at all, and to show a net income of $20,000 in State A whereas

the actual net income from the entire business is but $10,000 is clearly erroneous.

If in this example, the selling expenses had amounted to $60,000, the company would have had an actual loss of $10,000 ($150,000 gross receipts less $100,000 cost of manufacture, and $60,000 selling expenses). Under the separate accounting method, however, the conclusion would still be reached that the company realized a net income of $20,000 in State A, the State of manufacture. This conclusion is plainly absurd. It is no answer to point out that if it were not for the manufacturing activities, whereby the company obtained goods at a cost of $100,000 which it would otherwise have had to purchase at a cost of $120,000, the company would have had a $20,000 greater loss, and to argue therefrom that the manufacturing activities should be credited with an income of $20,000, the amount of the additional loss avoided. The fact is that the company is not engaged solely in the business of selling goods, but is engaged in the business of manufacturing and selling which sustained an actual loss of $10,000. To tax it on or measured by net income in any amount, under such circumstances, is to tax it on or measured by something that does not exist.

Even if some adequate and reasonable method of apportioning gross income in the case of a unitary business could be found, insurmountable difficulties would still be encountered in apportioning the ex-

penses and other deductible items among the various States in which the business is conducted. Such expenses and other deductible items are frequently apportioned by assigning to each State in which the business is conducted, the expenses directly incurred therein, such as rental for, and taxes and depreciation on property located there, and compensation for services performed there. Certain indirect or so-called central expenses, such as officers' salaries, advertising expense, and interest on money borrowed, which admittedly are not incurred wholly on account of the business carried on in any one State, are apportioned among all the States in proportion to gross receipts or gross sales or by some other formula. Although this method of apportioning direct expenses between States may be proper where the business in each State is separate and distinct from the business carried on in other States, where the business is a unitary business it is definitely inadequate and unsatisfactory. In the case of such a business, the place where expenses happen to be incurred has little or no bearing on the question of how such expenses should be allocated. This proposition is recognized in separate accounting in so far as the so-called central expenses are concerned, but it is denied when expenses locally incurred are concerned. It is, however, equally correct for both types of expense. In the case of a business consisting of the

manufacture and sale of goods, for instance, the incurring of selling expenses in a particular State may have a very definite bearing on the amount of income realized from sales in other States. The incurring of such expenses may result in greater sales. An increase in sales in turn requires an increase in production. An increase in production will result in a reduced per unit cost, resulting from spreading certain fixed or more or less constant charges, such as depreciation and taxes on the manufacturing plant, over a greater number of units, from increased purchasing power with a consequent reduction of cost per unit of raw material, or from a combination of these or other means. A decrease in the unit cost of goods manufactured, will in turn result in an increase in the profit or income realized from sales made in other States. The expenses incurred therefor have a direct bearing on the business as a whole, and should not be charged entirely against the gross income arbitrarily assigned to the State where incurred.

This method of apportioning so-called direct charges to the States where incurred is so arbitrary and ill-suited to the proper apportionment of income that it is possible that under this method the selling activities within a particular State may show either no income or a loss even though the entire gross income from sales made therein were apportioned thereto and even though the company incurring such expenses made a greater income

than it would otherwise have made. This point may be illustrated by the following example: A particular company is engaged in the manufacture and sale of products in State X. It manufactures 100,000 units at a cost of $100,000 which it sells for $125,000. The selling expenses amount to $20,000. The company thus has a net income of $5,000. The company decides to open a sales office in State Y. Through the efforts of this office additional sales of 100,000 units are made resulting in additional receipts of $125,000. Although the sales and consequently the units produced are doubled, the additional manufacturing costs amount to but $50,000 resulting in a per unit cost of 75 cents for 200,000 units in place of a per unit cost of $1 for 100,000 units as formerly. In order to increase its sales by 100,000 units, however, it was necessary to carry on an extensive selling campaign in State Y. Furthermore, rents, salaries and other expenses in State Y are proportionately higher than in State X. Thus the sales expenses incurred in State Y amount to $50,000 as compared to $20,000 in State X. Notwithstanding this relatively high selling expense, the company makes $30,000 net income ($250,000 gross receipts less $150,000 cost of manufacture, and less $70,000 selling expense of which $20,000 was incurred in State X and $50,000 in State Y), or $25,000 more income as a result of doing business in both States X and Y than it made when its business was confined to State X. Al-

though it would not be proper to assign the entire additional income to State Y, since it could not have been made without the manufacturing plant and sales in State X, certainly some portion of the income should be assigned to State Y; yet under the separate accounting method whereby so-called direct expenses incurred within a State are apportioned entirely to that State, no net income will be attributed to State Y, even though the entire gross income from the sales made therein are apportioned to that State. The gross income from sales made in State Y is $50,000; i. e., $125,000 gross receipts less $75,000 cost of goods sold (100,000 units x 75 cents, the per unit cost). If the direct expenses of $50,000 incurred in State Y are deducted, the answer is zero or no net income assigned to State Y.

If in this example the selling expenses incurred in State Y amounted to $60,000, the conclusion would be reached under the separate accounting method that the company operated at a loss of $10,000 in that State, notwithstanding the fact that the company made $20,000 from its entire business or $15,000 more by doing business in both States than it would have made if it had done business only in State X.

These results are clearly distorted. It can readily be appreciated that the results would be even more greatly distorted if a portion only of the gross income from the sales made in State Y were

assigned thereto and if in addition to the expenses in State Y a portion of the indirect or so-called central expenses were attributed to that State.

The foregoing examples are equally applicable to the case of a corporation engaging in the business of purchasing and selling goods in several States. Suppose that a company is engaged in the purchase and sale of goods in State A. It purchases 1,000,000 units at a per unit cost of $1, a total purchase price of $1,000,000. The goods are sold for $1,250,000. The selling expenses amount to $200,000. Its net income is thus $50,000. By doubling its purchases, the company is able to obtain lower prices and is thus able to buy 2,000,000 units at a total cost of $1,500,000, or at a per unit cost of 75 cents. It is able to double its purchases and thus obtain the reduced prices only by doubling its sales. To do this it is necessary to open a sales office in State B and to maintain an extensive sales organization therein. For various reasons the sales expenses in State B are unusually large and amount to a total of $600,000. The company nevertheless increases its profits from $50,000 to $200,000. ($2,500,000 gross receipts less $1,500,000 cost of goods sold and $800,000 selling expense, of which $200,000 was incurred in State A and $600,000 in State B.) Notwithstanding the fact that by virtue of the sales in State B the company made an additional income of $150,000, under the separate accounting method the conclusion would be reached that the activities

in State B resulted in a loss of $100,000. ($1,250,000 gross receipts from sales in State B minus $750,000 cost of goods sold=$500,000 gross income; deducting the $600,000 sales expense incurred in State B results in a loss of $100,000.)

In the same manner as in the above example, so in the instant case, the conclusion would be reached under the separate accounting method that appellant's sales activities in a number of States were operated at a loss, notwithstanding the fact that the appellant's business as a whole made income which could not have been made were it not for its ability to purchase in large quantities which in turn was made possible by virtue of the sales activities in the various States in which appellant does business.

Separate accounting also fails in other ways to reflect accurately the net income properly attributable to each State in which a buying and selling business operates. For instance, suppose X Corporation, a wholesale house which buys and sells general merchandise in State A, has overhead or central expenses of $100,000, consisting of officers' salaries, advertising costs, accounting expenses and similar expenses. In 1934 X Corporation sold 1,000,000 units in State A at $1 each for a profit of $10,000 ($1,000,000 gross receipts less $690,000 cost of goods sold less ~~$200,000~~ $200,000 direct selling expenses, less $100,000 central or overhead expenses=$10,000). But in 1935 X Corporation

moves into State B and in addition to its sales in State A sells 500,000 units in State B, making a total of 1,500,000 units sold in the two States. The excursion into State B did not result in a lower per unit cost for the goods sold and the per unit selling expenses in State B were higher than in State A. However, operations in State B only increased the overhead or central expenses by $20,000 to a total of $120,000. Thus as a result of the excursion into State B the corporation made a net income of $20,000 ($1,500,000 gross receipts less $1,035,000 cost of goods sold [$690,000 plus $345,000 equals $1,035,000] less $325,000 direct selling expenses less $120,000 central or overhead expenses=$20,000) or $10,000 more than the corporation had made when it sold only in State A. As the corporation made a greater income because it operated in State B obviously some of its net income is derived from State B. Under the separate accounting system of allocation, however, no income at all but a loss would be assigned to State B. ($500,000 gross income less $345,000 cost of goods sold less $125,000 direct selling expenses less $40,000 central or overhead expenses equals a $10,000 loss). The reason for the inaccuracy of separate accounting in this example is two-fold: one, it charges the entire direct expenses of selling to the State where those expenses are incurred (the fallacy of this has been discussed earlier); two, it assigns the central or overhead expenses to each

State on an arbitrary per-unit basis[1] instead of on a basis of actual experience. One reason the latter is done is because it is usually impossible to trace the cause of increased central expenses from one State to another. However, the impossibility of tracing this cause does not support the conclusion that increased central expenses *must* be charged against each sale or each State on a *percentage* basis. Instead, that conclusion is supportable only on either of two possible grounds; one, the desperate impossibility of a more accurate method; or, two, the assumption that an average or norm prevails throughout the States in which the business is done, which justifies assigning the central expenses on an average or formula basis. If the first of these grounds is the prevailing one, it is an admission of fallibility in the separate accounting system which prevents its being used as a gauge by which to test the accuracy of any other allocation system. If the second of these grounds is the prevailing one, it provokes the query of why the average or formula system should not be used to allocate all other items as well as central expenses, for if the

[1] This method of allocating central expenses was used in the separate accounting of Butler Brothers. 75% of the central expenses allocated to and charged against the California house would have been incurred even though the California house had not operated. (Stipulation of Facts, Para. 4. Record, p. 9.)

average is correct for any item it should be for all.[1]

In summation, a very simple example will serve to illustrate the inaccuracy of the premise on which separate accounting rests and of the results which it produces. Suppose Mr. X has in Tennessee a potential customer who will pay $100 for a horse. X finds that such a horse as this Tennessee customer wants will cost X $100, including transportation costs, so if X bought such a horse and sold it in Tennessee, he would not have any net income. However, X finds that while he must pay $100 for one horse he can buy two identical horses for $150, including transportation costs. But if X buys two horses for $150 and sells only one he will lose on the transaction even if he sells that one horse for $100. Then, however, X finds a customer in California who will pay him $75 for the second horse. The second sale will enable X to realize $175 from the transaction, or a gain of $25. So X sells one horse in Tennessee for $100 and the other in California for $75, thus getting a net income of $25. Under the separate accounting

[1] Accepting the propriety of using a formula to allocate some of the expenses, but attacking the propriety of using a formula to allocate other expenses and the gross income, is an inconsistency which vitiates the attack on the formula. *Norfolk & Western Ry. Co.* v. *Maxwell*, 297 U. S. 682.

Appellant has suggested that there is no issue between us regarding the propriety and accuracy of its allocation of central expenses. Appellant's understanding is not altogether correct. Inasmuch as we contend that a formula should be used to allocate appellant's net income, including therein its gross income and expenses, we naturally agree that the allocation of the central expenses by a formula is correct, and we so stipulated. We did not, however, stipulate or agree that the use of formula allocation of central expenses in conjuction with the direct allocation of other expenses and gross income was correct or proper, or tended to produce an accurate result.

method of allocation, X's entire gain would be allocated to Tennessee, because the horses were purchased for an average cost of $75 apiece and the only one which was sold for more than that was the horse which was sold in Tennessee. It would be fully as reasonable, however, to assign the entire income to California, because actually the first horse cost X $100 and the second one cost him $50, and the only horse which was sold for more than its cost price was the one sold in California. Actually neither solution is correct. Both sales were absolutely necessary steps in deriving the net income from the transaction, and the income is attributable to the two together, not to either one alone. Therefore, when the necessity arises of allocating the net income between the States in which the sales took place, each State must be credited with some of the net income. This may be done only by the use of a formula.

For the above reasons the conclusion is inescapable, as the California Supreme Court held, that the separate accounting method is wholly unsuited to the proper apportionment of the income of a unitary business. It is believed that the only proper method for making the apportionment is to employ a formula which gives weight to the various factors responsible for the earning of income, such as (1) *property*, which reflects the capital investment, (2) *pay roll*, which indicates the value to the taxpayer of the services of its employees, and

(3) *sales,* which give weight to the activity of the taxpayer in obtaining customers without which, of course, the business would not function.

Under the formula method the entire net income from the entire business is first determined by deducting from its entire gross income the total expenses and other deductible items. After this is determined income *unconnected* with the unitary business, such as gains from the sale of capital assets, interest on bonds, dividends on stock and other income from intangibles, which may be apportioned according to the location or situs of the property or otherwise, is excluded or deducted from the entire net income. The remainder of the income, constituting the net income from the unitary business, is apportioned among all the States in which business is conducted on the basis which the average of the factors of the formula within the State bears to the average of the total of such factors within and without the State.

This method is simple of application, and avoids the uncertainties, guesswork and conjecture incident to the separate accounting method. Furthermore, under this method income will not be attributed to any State unless the entire business of which the business within the State is an integral portion is operated at a profit. Likewise, losses will not be attributed to any State unless the entire business sustains a loss.

B. The business carried on by appellant is a unitary business

Appellant is engaged in the wholesale dry goods and general merchandise business. (R-8) Appellant buys goods through a central purchasing division and sells those goods through seven stores or houses, one of which is located in San Francisco, California. (R-8) Being wholesale stores, these stores sell exclusively to the retail trade. (Page 14, appellant's brief.) Thus appellant's business could not exist profitably unless appellant could buy the goods it sells more cheaply than the retailers to whom it sells could buy them elsewhere. Therefore appellant's ability to buy its goods at a low price is the primary cause of appellant's earning a net income in 1935 of $1,149,677.

The stipulated fact is that appellant is able to buy at lower prices because of the greater volume of purchases which it makes than it could if it were buying only for one of its stores. (R-10, para. 8) As the California Supreme Court pointed out, appellant is able to purchase in such volume only because it can sell in such volume. Thus the purchasing differential is made possible by the great volume of sales appellant makes, to which the California store adds. Thus the California store is a factor in enabling appellant to buy at reduced prices; i. e., to make a purchasing saving. Furthermore, the saving is not turned into profit until the sales are made. Thus, the purchasing activities

and the sales activities are interdependent and supplement one another to form one single, unitary business.

Appellant has attempted to draw the inference that the California house is not a factor in making possible this purchasing saving, by emphasizing the admitted fact that the addition to or deduction from the total purchases of an amount *equal to* the purchases made for the San Francisco store would not affect the purchasing differential. Appellant attempts to construe this fact as meaning that the California store did not contribute to the purchasing saving. Such a construction is erroneous, for as much reason exists for charging any of appellant's other stores with failure to contribute to the purchasing saving, to the extent of purchases in that amount, as exists for charging the California house with such failure.

The stipulation does not state that if the San Francisco house were eliminated the purchasing differential would not be affected, nor does it state that the purchases made for the San Francisco house could be eliminated without affecting the purchasing differential. It states that the addition or deduction of an amount of purchases "equal to" the purchases made for the San Francisco house "would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the Company." (R-10, 11, para. 9.) It is important

to observe that the stipulation refers to an amount of purchases *equal to* those made for the account of the San Francisco house. From paragraph 8 of the stipulation (R10) it appears that about $5,000,000 of purchases were made for the account of the San Francisco house. Thus all that the stipulation says and means is that the addition or subtraction of $5,000,000 of purchases would not affect the purchasing differential. That particular $5,000,000 of purchases is not tied up with the San Francisco house except that the latter is used as a measuring stick. The $5,000,000 of purchases may be those made for any house. It is economically impossible to select one house and charge it with responsibility for those purchases. They may as reasonably be the purchases of any one house as of any other. If appellant could successfully charge the California house with failure to cause the price differential, appellant could then proceed in turn to each of its other houses and successfully charge each of them with the failure. The result would be that all of the houses would be charged with failure to cause the price differential, whereas the stipulated fact is that they did cause it.[1]

A simple illustration will demonstrate why the California house can not be singled out as not contributing to the purchasing saving. Suppose seven metal blocks weighing 25 pounds apiece were laid

[1] If any one house must be charged with failure to cause the price differential, that house should be the Baltimore house, which was acquired last and joined the unitary group after the price differential had probably been achieved. (R-8, para. 1)

side by side on scales capable of registering only 150 pounds. Any one of those blocks, which total 175 pounds in weight, can be removed from the scales without causing the scales to register less than their 150 pound maximum. Remove them all and the scales will register zero. Which metal block is exclusively superfluous? Any block one wishes to select can be removed without changing the weight registered by the scales, but return it to its place on the scales and remove its neighbor. The result is the same; the scales are still tipped at 150 pounds. Thus it is apparent that each block is contributing to the same extent to keeping the scales tipped at 150 pounds and no one block can be accurately selected as the one block which is unnecessary. So it is with attempting to select one of appellant's seven houses and charge it exclusively with failure to cause a purchasing saving.

The centralized purchasing is a factor which makes appellant's business a unitary business. As the examples in the preceding section of this brief demonstrate, separate accounting does not accurately allocate the income of a buying and selling business with centralized purchasing, and the use of a formula is necessary.

Other facts characterizing appellant's business as unitary are appellant's central executives, a central advertising division, and central accounting. (R-9, para. 4)

The business of buying and selling in several States under conditions like those in this case has been held to be unitary in *Great Atlantic & Pacific Tea Co.* v. *Grosjean,* 301 U. S. 412, and in *International Elevator Co.* v. *Thoresen,* 58 N. Dak. 776, 228 N. W. 192. In the *Great Atlantic & Pacific Tea Co.* case the determination that an integrated buying and selling business was unitary led to a decision that a state chain store tax was valid although it was graduated according to the total number of stores in the chain, including out-of-state stores. In the *International Elevator Co.* case the determination that such a business was unitary led to a decision that a formula should be used to allocate its net income, instead of separate accounting.

Likewise the decisions in *Underwood Typewriter Co.* v. *Chamberlain,* 254 U. S. 113, *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Comm.,* 266 U. S. 271, and *North American Cement Corp.* v. *Graves,* 299 U. S. 517, support the conclusion that appellant's is a unitary business. In these cases this Court held that the business of manufacturing and selling was unitary, emphasis being laid on the fact that a corporation which manufactures goods for sale must sell them to derive income. As it is fully as true that a corporation which buys goods for sale must sell them to derive income, it follows from these cases that a buying and selling business conducted in several states is a unitary business.

As appellant's business is a unitary business, separate accounting is, for the reasons explored in the preceding division of this brief, inadequate to the task of allocating the net income between the respective States, and a formula must be used for that purpose.

C. This Court has already recognized that separate accounting does not correctly allocate the income of a unitary business and is insufficient evidence to establish that a formula has reached an unreasonable result

In at least two cases before this Court, an allocation by separate accounting was offered by the taxpayer as evidence that formula allocation had reached an erroneous or unreasonable result.

The first of these cases was *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113. To overthrow the State's formula allocation, the taxpayer offered an elaborate separate accounting allocation showing the gross receipts realized in Connecticut and those realized in other States, the expenses incurred in each State, and the amount by which the gross receipts from Connecticut exceeded the expenses incurred in that State. The result was claimed by the taxpayer to be the net income derived from Connecticut, and in a completely physical sense the taxpayer was right. Had each dollar of gross receipts been traced to the State in which the taxpayer had first acquired that dollar, and the appropriate deductions been taken

from it, the net result would have coincided with the taxpayer's allocation. This Court, however, recognized that the place of realization of gross receipts is not necessarily the place from which all the net income resulting from that realization is derived. Accordingly the Court held that the taxpayer's separate accounting allocation, which failed utterly to give weight to the income producing potentialities of the manufacturing process in Connecticut, was not sufficiently accurate an allocation to overthrow the presumption that the formula allocation was accurate. It is significant that the separate accounting allocation offered by the taxpayer in the *Underwood Typewriter* case is the same in general plan as that offered by appellant herein. It is also interesting, in view of appellant's discussion of the use of inferences by the California Supreme Court, to note that on page 19 of the brief of defendant in error in the *Underwood* case the State contended that the taxpayer's case was built upon "assumptions, inferences, assertions and hypotheses."

The other case is *North American Cement Corp.* v. *Graves,* 299 U. S. 517. This memorandum decision affirmed the New York Court of Appeals, which had affirmed without opinion a lower court which had also not written an opinion. Thus the facts of this case must be taken from the record, which shows that the taxpayer offered an elaborate

separate accounting allocation in an effort to overthrow the State's formula allocation. The taxpayer in this case operated two cement plants in New York, one in Maryland and a lime plant in West Virginia. According to the only evidence on the point in the record, (Page 75, Record, in the *North American Cement* case) the four plants were separately operated, separate accounts were kept for each, and very little output of the West Virginia and Maryland plants was sold in New York. The taxpayer's separate accounting allocated a small income to New York for 1925 and large losses for 1926, 1927 and 1929. The State's formula allocated large incomes to New York for each of those years. The separate accounting allocation (a representative example of this allocation may be found in the Appendix herein) was prepared by a distinguished accounting firm and certified by that firm to be accurate. The separate accounting first allocated net income (or a loss) to New York and then broke that figure down into the portion attributable to each of the New York plants. It is manifest that had the separate accounting in this case been deemed credible, the formula would have been shown to have operated unfairly against the taxpayer, but the formula allocation was upheld.

On page 39 of its brief appellant suggests that the separate accounting allocation in the *North American Cement* case was entitled to less weight than appellant's separate accounting allocation,

because appellant's is used for some purpose in addition to use for tax purposes, whereas the separate accounting allocation in the *North American Cement* case was used only for tax purposes. We cannot see how the conclusion reached by appellant would follow even if the facts were as appellant claims, for those facts have no bearing on the accuracy of the separate accounting allocation. However, the record herein fails to establish that the allocation made in appellant's local books was designed or used for any purpose other than tax purposes. On the other hand the separate accounting allocation in the *North American* case was required to be made by the terms of a bond issue (see p. 39 of the record in that case) and was used for that purpose as well as for tax purposes. As the separate accounting allocation in the *North American Cement* case was actually more detailed than that offered by appellant, we cannot see any reason for assuming appellant's to be more accurate than that in the *North American Cement* case.

Separate accounting allocation was also offered by the taxpayer in *Bass, Ratcliff & Gretton* v. *State Tax Comm.*, 266 U. S. 271, and was held insufficient to overthrow the formula allocation. However, the taxpayer's separate accounting allocation merely showed a loss from its United States business, 93% of which was transacted in New York. The Court's decision may have rested on the ground that showing a loss from the United States

did not prove that a loss had been suffered in New York, instead of on the ground of the general inappropriateness of separate accounting to the task. The Court's opinion, however, suggests that the latter was the ground chosen.

The decision in *Hans Rees' Sons* v. *North Carolina*, 283 U. S. 123, did not approve allocation by separate accounting.[1] What this Court held in the *Hans Rees* case was that where evidence was offered which showed without challenge that the formula allocated a much larger income to the taxing State than was fairly attributable to the business done within it, the particular formula allocation was not proper. The decision in that case left open the question of the type of evidence which would be accepted as proof of the inaccuracy of a formula allocation, because the State in the *Hans Rees* case at no time questioned the fact that the evidence did show that the formula allocated to the taxing State more income than was actually attributable to the business done within it.

A review of the record in the *Hans Rees* case is essential to a proper discussion of that case, as many important facts do not appear in the opinion. The record showed that whereas the State's formula allocated net income on the basis of the ratio of property owned in North Carolina to property owned everywhere, the taxpayer had a factory on

[1] The effect of this decision has been the subject of a critical discussion in "Interstate Allocation of Corporate Income," 40 Yale Law Journal 1273, 1 *Selected Essays on Constitutional Law*, V 272.

leased premises in New York. The particular allocation formula used did not allocate any of the taxpayer's net income to New York on account of that factory, yet a proper formula would not have ignored the fact that there was as much reason for the New York factory to be productive of some income as for the North Carolina factory to be. Furthermore, the inaccuracy of the particular formula used in that case was enhanced by the fact that Hans Rees' Sons had timber reserves in North Carolina (bark was used in their tanning operations). These reserves were not actively used in the production of income, yet some income was allocated to North Carolina on their account but none was allocated to New York on account of the factory in that State. Thus the formula in the *Hans Rees* case allocated over 80% of the net income to one factory and none to the other factory, obviously an unreasonable result. Even accepting North Carolina's assumption that most of the income was attributable to the manufacturing function, that would not justify attributing all the manufacturing income to the North Carolina factory to the exclusion of the New York factory. This fact must have influenced the final decision, as witnessed by the several references in the Court's opinion to the impropriety of allocating nearly the entire net income to North Carolina.

For evidence to prove that it was unjustly treated, Hans Rees' Sons did not offer a mere

separate accounting allocation. Instead, Hans Rees' Sons offered elaborate analyses of the causes of its profits. One line of evidence tended to show that the corporation's entire manufacturing activities were conducted at a loss in three of the four years involved. Another line of evidence tended to show that the entire manufacturing activities produced no profit in 1926, and 26%, 13% and 37% of the profit in the other three years, an average of 17%. Even assigning this entire profit to North Carolina and none to the factory in New York, still the income allocated to North Carolina by the formula was greatly in excess of the manufacturing profit.

North Carolina did not question that the evidence which was offered proved that the income actually attributable to North Carolina was far less than that which the formula allocated to that State. The North Carolina Supreme Court did not question it either, but held that the evidence was not material since the formula was not inherently arbitrary.

This Court did not hold that a formula was improper in the *Hans Rees* case. This Court merely held that a formula would not be sustained which allocated to the taxing State "a percentage of income out of all appropriate proportion to the business" transacted in that State. As the formula in the instant case consists of property, payroll and sales, the income allocated to California is in exact

proportion to the business done in California. This, we submit, is all that the *Hans Rees* case requires. Furthermore, even if that decision is authority that a loss can be attributed to one of the States in which a unitary business is conducted whereas the entire business is done at a substantial profit, the *Hans Rees* case does not support the view that separate accounting allocation is competent to establish the existence of that loss. As other decisions of this Court [1] are to the contrary, we submit that this Court has already recognized that separate accounting allocation is in–appropriate in the case of a unitary business.

D. Appellant has not shown that the formula does not accurately apportion its net income

The burden is upon appellant in attacking the formula

> "to make oppression manifest by clear, cogent evidence."—*Norfolk & Western Ry. Co.* v. *Maxwell,* 297 U. S. 682, 688.

We submit that appellant has not done this.

As this Court observed in the *Norfolk & Western* case,

> "What the formula does assume is this, that barring exceptional conditions there will be

[1] The most recent decision of this Court involving formula allocation, *Ford Motor Co.* v. *Beauchamp,* 308 U. S. 331, is a sweeping approval of the right of the States to use formula allocation. Although the tax in that case was measured by capital employed in the State rather than by net income, the decision affords support to appellee's position herein since the taxpayer, relying on the *Hans Rees* case, unsuccessfully offered a breakdown of property employed in the State which was analogous to separate accounting allocation of income.

throughout the system such an average relation between revenues and expenses as will cause the net income of a part to vary, in proportion to the mileage, with the net income of the whole. The implications of the formula being what they are, a taxpayer does not escape the application of the statute by evidence directed to only one of the related terms. Its evidence to be effective must be directed to each of them alike, for only by this can the assumed relation between them be proved to be unreal."—297 U. S. 682, 688.

Appellant has not made any effort to show any variance in California from the norm. If operations in California produced a loss whereas like operations elsewhere produced a profit, there must have been reasons for it, reasons which would give meaning and add substance to the bookkeeping loss shown by appellant's separate accounting system. No reason has been shown, nor has a single fact been shown which would tend to prove that the California operations or conditions differed from those found elsewhere. In the absence of a showing of exceptional conditions such as to negate the assumption that in California the relation between revenues and expenses is the same as it is in the other States in which appellant does business, a showing that the formula produces an improper result has not been made.

Appellant has not shown the source of its entire net income of over $1,000,000. For all that appears from the showing made by appellant, the use of

separate accounting allocation might allocate a loss to each of its stores in turn. If the factors which produce appellant's entire net income are present in the other States and absent from California, that fact has not been shown.

The facts as stipulated constitute appellant's entire showing, and they merely show that by the bookkeeping system which appellant used appellant computed a loss from its California operations. The bookkeeping system used by appellant was separate accounting, and, as we have heretofore shown, that accounting method does not tend to allocate accurately the net income of a unitary business. Furthermore, as we have shown, appellant's separate accounting accepts the formula method of allocation as to central expenses but rejects it in allocating other expenses and gross income; this inconsistency is the same as that which vitiated the attack on the formula in the *Norfolk & Western* case.

E. Formula allocation is the only practicable method of allocation

A decision sustaining the erroneous contention that a unitary business operating in seven States can be divided up by accounting into seven separate businesses, each with its own system of separate accounts and its own separate allocation of income, would be an incalculable threat to the survival of a system of state taxation of or measured by net income. In addition to being incurably fictitious,

such separate accounting is, unfortunately, open to manipulation by taxpayers desirous of evading their just taxes.

Such separate accounting requires that the figures in locally maintained books be used, yet invariably some of the items shown on the local books are mere reflections of figures and items developed at the central office and shown on the books there. Examples of this in the instant case are the cost of goods sold, the freight charges, and the central expenses. The accuracy of such figures cannot be verified by an inspection or audit of the local books, but only by an audit of the books maintained at the head office, or in the case of a manufacturing corporation at the factory, or both. As States do not have extraterritorial powers they cannot compel that these books, maintained at offices or plants outside their borders, be made available for their inspection and audit. Thus the States will have no way of checking the local books against entries in the central office books and will be at the mercy of the taxpayers.

We do not mean to suggest that appellant has been or would be guilty of such practices, but if a precedent be established upholding separate accounting allocation in this case, that precedent will certainly be used by other taxpayers, and if their local accounts be inaccurate that fact will not be ascertainable or provable by the taxing State.

Formula allocation is not susceptible to this manipulation. For instance, to operate the formula used herein both local and total tangible property, payroll and sales must be ascertained. The local figures are all truly local, i.e., they are not dependent on or a reflection of figures primarily shown on the books at the head office. Thus they may be fully verified by an audit of the local books. The figures representing the totals may all be verified from figures and information possessed and usually made available to the States by the Bureau of Internal Revenue.

Furthermore, use of a formula avoids reliance on such imponderables as fair market value. Where the State wherein a manufacturing plant or purchasing division functions wishes to allocate income to itself for tax purposes, or where a taxpayer wishes to allocate income to that State to avoid its being taxed elsewhere, if separate accounting allocation is to be used a fair market value of the goods will need to be determined. This value will not, however, be the retail value of the goods—it will be a figure intermediate between cost and retail value. It will necessarily be a fictional figure, not produced by the taxpayer's experience with these goods. Thus its use will often allocate fictitious, unrealized income to some States and equally fictitious losses to others. Furthermore, its use will introduce endless administrative difficulties and disputes unless

the decision of either the taxpayer or tax administrator is to be given the same finality that the assessment of the assessor or assessing body has in the field of property taxation.

The use of formula allocation avoids these difficulties and makes for more uniform, more practical tax administration.

II. The California Supreme Court did not err in refusing to reopen the case to permit appellant to show further facts, but had it erred that error would not have constituted a denial of due process

Paragraph 12 of the Stipulation of Facts (R-11, 12) provides that:

> ". . . if . . . the Court deems . . . that this stipulation fails to establish any fact necessary to a decision, the case shall be reopened for the taking of further proof in respect thereof."

This stipulation provides that the case shall be reopened for further evidence if the Court deems it necessary, not if appellant does. Appellant is objecting, therefore, because the California Supreme Court did not deem it necessary, but inasmuch as the stipulation left this in that court's discretion, its action is final.

Furthermore, we call attention to the fact that the further facts which appellant in its petition for rehearing below for the first time offered to prove are for the most part entirely foreign to appellant's

original theory of its case, which is that allocation by separate accounting is of itself sufficient evidence to overthrow a formula. The only facts which are not foreign to its original theory are those which would discount the importance of the central advertising, and as the court only relied incidentally on that feature, such additional showing would not have changed its decision.

Finally, we submit that the Constitution does not compel the courts of California to allow a case to be tried over and over on as many different theories as the ingenuity of counsel can devise. The procedure by which State courts dispense justice is not a federal question so long as a fair hearing and opportunity to be heard are afforded. (*Iowa Central Ry. Co.* v. *Iowa*, 160 U. S. 389, 393.) Surely a State court can compel litigants before it to comply with rules requiring the presentation of a litigant's entire case at one hearing. If this can not be done, all State rules regarding res judicata, splitting causes of action and defenses would be reviewable by this Court. Heretofore the only limitation placed by this Court on the power of the States to apply their own rules of this sort is in the field of class litigation, where the rule of res judicata has not been permitted to bind litigants unless they have been parties to or properly represented in the previous decision. (*Hansberry* v. *Lee*, 311 U. S. 32.) The situation

presented herein is not comparable to that presented by class litigation, for here appellant has throughout the proceeding been before the court and is a party to the litigation. The situation herein is comparable to the instances in which this Court has held that the rules of State courts requiring the presentation of contentions at certain times are not reviewable by this Court even though their application prevents the consideration of a federal question. (*Central Union Co.* v. *Edwardsville,* 269 U. S. 190; *John* v. *Paullin,* 231 U. S. 583; *Chesapeake & Ohio Ry. Co.* v. *McDonald,* 214 U. S. 190; *Hulbert* v. *Chicago,* 202 U. S. 275; *Jacobi* v. *Alabama,* 187 U. S. 133; *Iowa Central Ry. Co.* v. *Iowa,* supra; *Brown* v. *Massachusetts,* 144 U. S. 573.)

Appellant herein had the same opportunity to present evidence in the trial court that any other litigant has. There is nothing peculiar in the procedure in tax cases in the California courts. Appellee stipulated to the facts which appellant wished to establish, which constituted appellant's showing on its theory of the case. Thus appellant had an ample opportunity to present its case. After judgment in the trial court appellant did not move for a new trial or otherwise indicate that it wished to reopen the case. Instead appellant appealed to the California Supreme Court. That court might have remanded the case for the taking of additional evidence but it did not do so. It has

not expressed its reasons for that action, but it may have felt that to permit parties by stipulation to set aside the normal rules of procedure and allow a plaintiff to present its case piecemeal would unduly lengthen the course of litigation, thus encumbering and burdening the courts and delaying other litigants. In such a view to re-try the case would be contrary to the best interests of the public and therefore contrary to public policy. The due process clause does not, it is submitted, compel any other result.

CONCLUSION

A fair analysis of appellant's argument is that it must be allowed to use whatever method of keeping its books which it chooses, as the method for allocating its net income for tax purposes. The consequence of appellant's argument is that appellant be permitted to choose the basis for taxation which it itself chooses. The Constitution does not give appellant this privilege. The State is a sovereign with power to legislate, and the right to determine the basis of taxation to which appellant must submit belongs to the State, subject only to the requirement that the values which the State allocates to itself as the measure of the tax shall be fairly

proportioned to the business done in the State. The tax herein does not offend that requirement, so the judgment below, which so holds, is correct and should be affirmed.

Dated: January 5, 1942.

Respectfully submitted.

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APPENDIX

NORTH AMERICAN CEMENT CORPORATION

Albany, New York

Exhibit A—Segregation of Net Income Earned on Business Done in New York State and Outside New York State for the Year Ending December 31, 1927.

		New York State			Outside New York State		
	Total	Albany District	Howes Cave Plant	Catskill Plant	Hagerstown District	Security (Md.) Plant	Berkeley (W. Va.) Plant
Gross Profit	$1,634,202.10	$493,968.41	$292,707.00	$201,261.41	$1,140,233.69	$1,062,370.88	$77,862.81
Miscellaneous income	7,744.82	2,959.08			4,785.74		
	$1,641,946.92	$496,927.49			$1,145,019.43		
Selling and Administrative Expense—Cement	750,583.82[a]	422,653.75			327,930.07		
(Portion of expenses chargeable to each district is the ratio of cement shipped from each district to total cement shipped from all plants)							
Albany Dist.							
Howes Cave 740,868							
Catskill 1,166,557							
Total N. Y. State 1,907,425—56.31%							
Security (Md.) 1,480,170—43.69%							
Total all plants 3,387,595 bbls.							
Selling and Administrative Expense—Line (W. Va.)	84,452.00				84,452.00		
Operating profit	$806,911.10	$74,273.74			$732,637.36		
Interest and financial expense, including interest on debentures and amortization of discount	542,215.91[b]	276,211.35			266,004.56		
	$264,695.19	$(201,937.61)			$466,632.80		
Add: Non-deductible items:							
Increase in reserve for insurance	3,231.90				3,231.90		
Increase in reserve for repairs	303.94				303.94		
Taxes paid on Company tax free bonds	4,432.47	2,257.90 (50.94%)			2,174.57 (49.06%)		
	$272,663.50	$(199,679.71)			$472,343.21		

(a) Selling and administrative expense—Total		$843,498.13
Add: Interest on bank loans, etc.		21,452.70
		864,950.83
Deduct: Miscellaneous general income		29,915.01
		$835,035.82
Berkeley plant district expense	70,452.00	
Portion of general administrative expenses applied to Berkeley	14,000.00	
(See L. R. B. & M. certificate to Empire Trust Co.)		
Total lime dept. selling and administrative expense		$84,452.00
Applied to cement		$750,583.82
(b) Total property values in New York State and outside New York State at December 31, 1926, when the major construction program had been completed, and for which the proceeds of the 6½% debentures were used		$14,713,435.10
Deduct: Catskill plant		4,716,249.17
Balance, representing value of Howes Cave, (N. Y.) plant and Security (Md.) and Berkeley (W. Va.) plants		$9,997,186.93
Howes Cave (N. Y.) plant	35.29%	$3,527,846.01
Security (Md.) and Berkeley (W. Va.) plants	64.71%	6,469,340.92
		$9,997,186.93
Total bond interest and amortization		$542,215.91
Deduct: Catskill plant (See L. R. B. & M. statement attached for amount allotted to the Catskill plant)		131,144.11
Balance to be allotted to operations of Howes Cave (N. Y.) plant and Security (Md.) and Berkeley (W. Va.) plants		411,071.80
Howes Cave (N. Y.)—36.29%	$411,071.80	$145,067.24
Catskill (N. Y.) plant		131,144.11
Total New York State	50.94%	276,211.35
Outside New York State—64.71%	$411,071.80	
	49.06%	266,004.56
		$542,215.91
Tax assessed as follows:		
Gross assets—% N. Y. State	56.777%	
Taxable net income (272,663.50 x 56.777%)		$154,810.16
Tax at 4½%		6,966.45
Notice of assessment dated 12/27/28—File No. A-657409		
Date tax paid—Jan. 15, 1929 (Receipt dated 2/11/29).		

NORTH AMERICAN CEMENT CORPORATION

Income Account for the Catskill Plant for the year ended December 31, 1927

Sales, net of returns, allowances and discounts			$1,655,959.98
Cost of sales			1,454,698.57
Gross profit			201,261.41
Add: Miscellaneous plant income			1,179.47
			202,440.88
Selling and administrative expenses		$843,498.13	
Interest on bank loans, etc		21,452.70	
		864,950.83	
Less:			
Miscellaneous general income	$29,915.01		
Berkeley plant district expenses	70,452.00		
Portion of general administrative expenses applied to Berkeley plant	14,000.00		
		114,367.01	
		$750,583.82	
Portion of expense chargeable to Catskill 34.44% the ratio of cement shipped from Catskill to total cement shipped from all plants			258,501.07
Operating profit			56,060.19
Interest and financial expense, including interest on debentures and amortization of discount, 21.7% of $524,995.91 (21.7% represents the ratio $1,650,000 par value of 6½% debentures to the total outstanding February 11, 1926, of $7,597,000). Additions to plant facilities February 11, 1926, to December 31, 1926, totaled approximately $1,875,000		$113,925.11	
Interest on first mortgage 6% bonds for year ended December 31, 1927		17,220.00	131,144.11
Net loss		(Deficit)	187,304.30

We have examined the accounts and records of the North American Cement Corporation for the year ended December 31, 1927. Based upon this examination we certify that, in our opinion, the

above statement fairly reflects the results of the operations of the Catskill plant for the year ended December 31, 1927.

Lybrand, Ross Bros. & Montgomery,
Accountants and Auditors.

New York, January 23, 1928.

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SUPREME COURT OF THE UNITED STATES.

No. 283.—October Term, 1941.

Butler Brothers, Appellant, *vs.* Charles J. McColgan, as Franchise Tax Commissioner of the State of California.	Appeal from the Supreme Court of the State of California.

[March 2, 1942.]

Mr. Justice Douglas delivered the opinion of the Court.

This is an appeal (Judicial Code § 237(a), 28 U. S. C. § 344(a)) from a final judgment of the Supreme Court of California sustaining the validity of a statute of California against the claim that as construed and applied to appellant it violated the Fourteenth Amendment. 17 Cal. 2d 664, 111 Pac. 2d 334. The statute in question is the Bank and Corporation Franchise Tax Act. 2 Gen. L., Act 8488, p. 3851; Stat. 1929, p. 19; amended, Stat. 1931, p. 2226; Stat. 1935, p. 965. Sec. 4(3) of that Act provides for an annual corporate franchise tax payable by a corporation doing business within the State. The tax is measured by the corporation's net income and is at the rate of four per cent "upon the basis of its net income" for the preceding year. The minimum annual tax is $25. Sec. 10 prescribes the method for computing the net income on which the tax is laid. It provides in part:

"If the entire business of the bank or corporation is done within this State, the tax shall be according to or measured by its entire net income; and if the entire business of such bank or corporation is not done within this State, the tax shall be according to or measured by that portion thereof which is derived from business done within this State. The portion of net income derived from business done within this State, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, pay roll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation."

The tax in dispute is for the calendar year 1936. Appellant paid the minimum tax of $25, asserting that it operated in California during 1935 at a loss of $82,851. The tax commissioner made an additional assessment of $3,798.43 which appellant paid, together with interest, under protest. This suit was brought to recover back the amount so paid on the theory that the method of allocation employed by the tax commissioner attributed to California income derived wholly from business done without that State.

The facts are stipulated and show the following. Appellant is an Illinois corporation qualified to do business in California. Its home office is in Chicago, Illinois. It is engaged in the wholesale dry goods and general merchandise business, purchasing from manufacturers and others and selling to retailers only. It has wholesale distributing houses in seven states, including one at San Francisco, California. Each of its houses in the seven states maintains stocks of goods, serves a separate territory, has its own sales force, handles its own sales and all solicitation, credit and collection arrangements in connection therewith, and keeps its own books of account. For the period in question, all receipts from sales in California were credited to the San Francisco house. Appellant maintains a central buying division through which goods for resale are ordered, the goods being shipped by manufacturers to the houses for which they are ordered. All purchases made by appellant for sale at its various houses are made through that central buying division. The cost of the goods and the transportation charges are entered on the books of the house which receives the goods. No charges are made against any house for the benefit of appellant or any of its other houses by reason of the centralized purchasing. But the actual cost of operating the centralized buying division is allocated among the houses. The greater part of appellant's other operating expenses is incurred directly and exclusively at the respective houses. Certain items of expense are incurred and paid by appellant for the benefit of all the houses and allocated to them. No question exists as to the accuracy of the amounts of such expense or the method of allocation. The latter admittedly followed recognized accounting principles. For the year 1935 the amount of such allocated expense charged to the San Francisco house was $100,091. For purposes of this suit it was agreed that approximately 75% of that amount would have been

incurred even though the San Francisco house was not operated. The accuracy and propriety of the basis of allocation of those common expenses for 1935 were admitted. Included in such expenses were executive salaries, certain accounting expenses, the cost of operating a central buying division, and a central advertising division. Except for such common expenses, each house is operated independently of each other house. Appellant computed its income from the San Francisco house for the period in question by deducting from the gross receipts from sales in California the cost of such merchandise, the direct expense of the San Francisco house, and the indirect expense allocated to it. By that computation a loss of $82,851 was determined. In the year 1935 the operations of all houses of appellant produced a profit of $1,149,677. The tax commissioner allocated to California 8.1372 per cent. of that amount. That percentage was determined by averaging the percentages which (a) value of real and tangible personal property, (b) wages, salaries, commissions and other compensation of employees, and (c) gross sales, less returns and allowances, attributable to the San Francisco house bore to the corresponding items of all houses of appellant. No other factor or method of allocation was considered. The propriety of the use of that formula is not questioned if by reason of the stipulated facts a formula for allocation to California of a portion of appellant's income from all sources is proper.

The stipulation also states that in the year 1935 the total sales made by appellant at all its houses amounted to $66,326,000, of which $5,206,000 were made by the San Francisco house. The purchases made for the account of that house were substantially in the same proportion to total purchases. By reason of the volume of purchases made by appellant "more favorable prices are obtained than would be obtainable in respect of purchases for the account of any individual house". The addition of purchases "in an amount equal to the purchases made for the account of the San Francisco house results in no more favorable prices than could be obtainable in respect of purchases in an amount equal to the purchases which would be made" by appellant for its other houses if the San Francisco house was not in existence; and "a reduction in the volume of purchases in an amount equal to the purchases made for the San Francisco house would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses" of appellant.

Hans Rees' Sons, Inc. v. *North Carolina*, 283 U. S. 123, constitutes appellant's chief support in its attack on the formula employed and the tax imposed by California. Appellant maintains that the use of the formula in question resulted in converting a loss of $82,851 into a profit of over $93,500 and that the difference of some $175,000 has either been created out of nothing or has been appropriated by California from other states.

We take a different view. We read the statute as calling for a method of allocation which is "fairly calculated" to assign to California that portion of the net income "reasonably attributable" to the business done there. The test, not here challenged which has been reflected in prior decisions of this Court, is certainly not more exacting. *Bass, Ratcliff & Gretton, Ltd.* v. *Tax Commission*, 266 U. S. 271; *Ford Motor Co.* v. *Beauchamp*, 308 U. S. 331. Hence if the formula which was employed meets those standards, any constitutional question arising under the Fourteenth Amendment is at an end.

One who attacks a formula of apportionment carries a distinct burden of showing by "clear and cogent evidence" that it results in extraterritorial values being taxed. See *Norfolk & Western Ry. Co.* v. *North Carolina*, 297 U. S. 682, 688. This Court held in *Hans Rees' Sons, Inc.* v. *North Carolina, supra*, p. 135, that that burden had been maintained on a showing by the taxpayer that "in any aspect of the evidence" its income attributable to North Carolina was "out of all appropriate proportion to the business" transacted by the taxpayer in that State. No such showing has been made here.

It is true that appellant's separate accounting system for its San Francisco branch attributed no net income to California. But we need not impeach the integrity of that accounting system to say that it does not prove appellant's assertion that extraterritorial values are being taxed. Accounting practices for income statements may vary considerably according to the problem at hand. Sanders, Hatfield & Moore, A Statement of Accounting Principles (1938), p. 26. A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders. Cf. Hamilton, Cost as a Standard for Price, 4 Law & Contemporary Problems 321. That may be due to the fact, as stated by Mr. Justice Brandeis in *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113, 121, that a State in attempting to

place upon a business extending into several States "its fair share of the burden of taxation" is "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." Furthermore, the particular system used may not reveal the facts basic to the State's determination. *Bass, Ratcliff & Gretton, Ltd.* v. *Tax Commission, supra*, p. 283. In either aspect of the matter the results of the accounting system employed by appellant do not impeach the validity or propriety of the formula which California has applied here.

At least since *Adams Express Co. v. Ohio*, 165 U. S. 194, this Court has recognized that unity of use and management of a business which is scattered through several States may be considered when a State attempts to impose a tax on an apportionment basis. As stated in *Hans Rees' Sons, Inc.* v. *North Carolina, supra*, p. 133, " . . . . the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business, and all the factors in that enterprise are essential to the realization of profits." And see *Bass, Ratcliff & Gretton, Ltd.* v. *Tax Commission, supra*, p. 282. By the same token, California may properly treat appellant's business as a unitary one. Cf. *Great Atlantic & Pacific Tea Co.* v. *Grosjean*, 301 U. S. 412. There is unity of ownership and management. And the operation of the central buying division alone demonstrates that functionally the various branches are closely integrated. Admittedly, centralized purchasing results in more favorable prices being obtained than if the purchases were separately made for the account of any one branch. What the savings were and what portion is fairly attributable to the volume contributed by the San Francisco branch do not appear. But the concession that a reduction or addition of purchases "in an amount equal to the purchases made for the San Francisco house" would not result in higher or lower purchase prices respectively does not aid appellant's case. There is no justification on this record for singling out the San Francisco branch rather than another and concluding that it made no contribution to those savings. As aptly stated by the Supreme Court of California, "If the omission of the California sales would have no effect on the purchasing power, the omission of sales in an equal amount wherever made would likewise have no effect on the company's ability to purchase at a saving. Thus, by proceeding in turn from state to state, it could be shown that none of the sales in any of the states should be credited with the income resulting

from the purchasing of goods in large quantities." Nor are there any facts shown which permit the conclusion that the other advantages of centralized management (*Great Atlantic & Pacific Tea Co.* v. *Grosjean, supra*) are attributable to other branches but not to the one in California. The fact of the matter is that appellant has not shown the precise sources of its net income of $1,149,677. If factors which are responsible for that net income are present in other States but not present in California, they have not been revealed. At least in absence of that proof, California was justified in assuming that the San Francisco branch contributed its aliquot share to the advantages of centralized management of this unitary enterprise and to the net income earned.

We cannot say that property, pay roll, and sales are inappropriate ingredients of an apportionment formula. We agree with the Supreme Court of California that these factors may properly be deemed to reflect "the relative contribution of the activities in the various states to the production of the total unitary income", so as to allocate to California its just proportion of the profits earned by appellant from this unitary business. And no showing has been made that income unconnected with the unitary business has been used in the formula.

The stipulation of facts states that if "the Court deems that it is bound by any inference or presumption respecting the assessment made by the Commissioner, or that this stipulation fails to establish any fact necessary to a decision, the case shall be reopened for the taking of further proofs in respect thereof." Appellant in its petition for rehearing before the Supreme Court of California relied on that part of the stipulation in urging that the cause be remanded for a further hearing since that Court concluded that "appellant has not furnished any explanation of why its California business differs so from the average that the formula produced an erroneous result." The petition for rehearing was denied. Appellant now asserts that it has been denied procedural due process under the rule of *Saunders* v. *Shaw*, 244 U. S. 317. We do not agree. The Supreme Court of California created no innovation and sprung no surprise when it placed on appellant the burden of establishing that the formula taxed extraterritorial values. As we have noted, that is settled doctrine. Appellant had a full opportunity to be heard on the issues which it tendered.

Affirmed.